EIRIS

# Risky business

## – a global spotlight on corporate sustainability

EIRIS Sustainability Report, June 2013

## Are companies addressing all the sustainability risks and opportunities in their sector?

**One of the many services that EIRIS offers its clients is the ability to assess the sustainability performance of more than 2,000 global large cap companies using the EIRIS Global Sustainability Ratings product. This second in a series of reports on sustainability focuses on EIRIS' assessments of some of the largest companies globally, identifying any significant changes that have occurred between the previous year's sustainability assessment and current company performance.**

This year the data for 50 of the largest global companies has been presented grouped by sector, so that investors can easily recognise the sustainability leaders and laggards within those sectors.

The report also examines a current topical issue within sustainability, that of water resources, by exploring how corporates, highly exposed to water throughout their business operations and supply chains, are seeking to manage the risks and opportunities associated with water resources. Investors need to consider these potential risks and opportunities from an investment perspective, and make sure that the companies they invest in are aware of their exposure to sustainability issues arising from problems such as water scarcity.

### Key points:

- Nearly 40% of the 50 largest companies are managing their sustainability risks well but 25% are still performing poorly.
- Amongst the poor performers are global brands such as Apple, Wal-Mart and Amazon. The potential risk to the reputation of a brand from poor ESG performance means that sustainability risks are also financial risks.
- Commonwealth Bank of Australia, HSBC Holdings, Merck and Company, Nestle and Qualcomm have all improved on last year's ratings grade. JP Morgan and Samsung Electronics have slipped a grade.
- It is possible to identify sector leaders and laggards using the EIRIS Global Sustainability Ratings tool. For instance ExxonMobil and Chevron Corporation lag a long way behind their Oil and Gas super major peers Shell, BP and Total.

# EIRIS Global Sustainability Ratings

Sustainable development was first defined in the Brundtland Report for the UN (1987) as 'development which meets the needs of the present without compromising the ability of future generations to meet their own needs'. It is this principle that informs the EIRIS approach to sustainability, and that has been integrated into the development of the EIRIS Global Sustainability Ratings tool.

The EIRIS Global Sustainability Ratings grade companies on an A to E scale based on their longer term sustainability prospects. EIRIS Global Sustainability Ratings research offers investors the opportunity to compare companies within their sector, country or region, on a combination of factors. The ratings can help with identifying the companies that could be considered 'best-in-class', or possibly a cause of concern and therefore potentially suitable for engagement, as well as highlighting the key Environmental, Social and Governance (ESG) issues on which investors should focus.

This report publishes the Sustainability Ratings grade for a group of 50 of the largest (by market capitalisation) and most high profile global companies. Where a company's grade has changed from last year we examine the reasons for those changes. Also included in the paper is a case study on how companies manage their water risk and the implications this may have for their long term sustainability.

# EIRIS' analysis of the 'mega caps'

To provide a snapshot of how the world's biggest companies compare when it comes to managing their sustainability risks, EIRIS has created the table below showing the EIRIS Global Sustainability Rating grades[1] of some of the largest and most high-profile companies globally[2] (by market capitalisation).

The table is ordered by sector to enable comparisons to be made between the leaders and laggards in each sector and between sectors as a whole.

Given the size, global reach and resources available to these extremely large, global companies the expectation of investors should be that the management teams within these companies understand the risks to their businesses from sustainability issues, and demonstrate their leadership in tackling these issues. Thus creating a longer-term competitive advantage for the business overall.

As the table below shows, there is a mixed picture of how well the companies in the list are managing their sustainability risks. There are 19 out of the 50 companies (38%) that score either an A or a B, which indicates that these companies have implemented effective management responses to the various sustainability risks that they face. However, there are 13 companies that score a D or an E (26%) and these companies face a heightened risk of suffering future financial losses as the result of not effectively managing the sustainability factors that threaten their businesses.

[1] Assessment grades correct as at 31 May 2013

[2] Market capitalisation figures correct as at 31 May 2013

| COMPANY | Country | Sector | 2013 | 2012 |
|---|---|---|---|---|
| United Technologies | USA | Aerospace & Defence | C | C |
| Toyota Motor | Japan | Automobiles & Parts | C | C |
| Wells Fargo | USA | Banks | A | A |
| HSBC Holdings | UK | Banks | B | C |
| Royal Bank of Canada | Canada | Banks | B | B |
| Bank of America | USA | Banks | C | C |
| Citigroup | USA | Banks | C | C |
| Commonwealth Bank of Australia | Australia | Banks | C | D |
| J P Morgan Chase & Co. | USA | Banks | D | C |
| PepsiCo | USA | Beverages | C | C |
| The Coca-Cola Company | USA | Beverages | C | C |
| Bayer | Germany | Chemicals | A | A |
| BASF | Germany | Chemicals | B | B |
| VISA | USA | Financial Services | D | D |
| AT&T | USA | Fixed Line Telecommunications | C | C |
| Verizon Communications | USA | Fixed Line Telecommunications | C | C |
| Nestle | Switzerland | Food Producers | B | C |
| General Electric | USA | General Industrials | C | C |
| Amazon.com | USA | General Retailers | D | D |
| Home Depot | USA | General Retailers | D | D |
| Wal-Mart Stores | USA | General Retailers | D | D |
| Procter & Gamble | USA | Household Goods & Home Construction | C | C |
| Comcast | USA | Media | C | C |
| The Walt Disney Company | USA | Media | C | C |
| BHP Billiton (Australia) | Australia | Mining | B | B |

| COMPANY | Country | Sector | 2013 | 2012 |
|---|---|---|---|---|
| Vodafone Group | UK | Mobile Telecommunications | B | B |
| Berkshire Hathaway | USA | Non life Insurance | D | D |
| BP | UK | Oil & Gas Producers | B | B |
| Royal Dutch Shell | UK | Oil & Gas Producers | B | B |
| Total | France | Oil & Gas Producers | B | B |
| Chevron Corporation | USA | Oil & Gas Producers | E | E |
| ExxonMobil | USA | Oil & Gas Producers | E | E |
| Schlumberger | USA | Oil Equipment, Services & Distribution | B | B |
| GlaxoSmithKline | UK | Pharmaceuticals & Biotechnology | A | A |
| Merck & Company | USA | Pharmaceuticals & Biotechnology | A | B |
| Novartis | Switzerland | Pharmaceuticals & Biotechnology | A | A |
| Roche Holding | Switzerland | Pharmaceuticals & Biotechnology | A | A |
| Sanofi | France | Pharmaceuticals & Biotechnology | A | A |
| Johnson & Johnson | USA | Pharmaceuticals & Biotechnology | B | B |
| Pfizer | USA | Pharmaceuticals & Biotechnology | C | C |
| Microsoft | USA | Software & Computer Services | C | C |
| Oracle | USA | Software & Computer Services | C | C |
| Google | USA | Software & Computer Services | D | D |
| International Business Machines | USA | Software & Computer Services | D | D |
| Intel | USA | Technology Hardware & Equipment | B | B |
| Cisco Systems | USA | Technology Hardware & Equipment | C | C |
| Qualcomm | USA | Technology Hardware & Equipment | C | D |
| Apple | USA | Technology Hardware & Equipment | D | D |
| Samsung Electronics | South Korea | Technology Hardware & Equipment | D | C |
| McDonald's | USA | Travel & Leisure | D | D |

## Distribution of grades:

| A | B | C | D | E |
|---|---|---|---|---|
| 14% | 24% | 38% | 20% | 4% |

There are some very well known brands amongst the laggards including Google, Apple, McDonald's and Wal-Mart. Unless these companies improve the management of their sustainability risks they are in danger of seeing the value of their brands diminished. To use Apple as an example, the company received negative press coverage in September 2012 over allegations that Chinese students had been taken out of school and forced to work in a factory assembling Apple products.[3] Apple's Global Sustainability Rating score has been downgraded as the result of EIRIS' assessment of the company's response to this breach of the core International Labour Organization convention on forced labour.

EIRIS has designed the Global Sustainability Ratings so that each sector has its own risk profile and companies are assessed on the extent to which they manage their sector risks compared to other companies. This is to enable investors who integrate sustainability analysis into their investment model to identify both leaders and laggards. Use of the Global Sustainability Ratings can provide visibility to investors on which company management teams look to incorporate financially material sustainability risks and of equal importance opportunities into their forward looking business strategy, and which ones don't.

For example, the Oil and Gas Producers sector is one that has a significant number of sustainability risks associated with it. However, it is not the case that all companies in this sector score poorly. Amongst the super majors, Royal Dutch Shell, BP and Total have been assessed at a rating of B, which means they are going some way towards managing the considerable sustainability risks in the sector. However, ExxonMobil and Chevron Corporation have both been assessed at a rating of E, the lowest grade, suggesting that they are failing to manage their sector risks. These two companies are of particular concern to investors as they are two of the largest companies in the world by market capitalisation, and, as such, they will be held in many portfolios.

A further example of the value that the Sustainability Ratings can provide in selecting sector leads and laggards, is in the Pharmaceuticals and Biotechnology sector. There are five companies in the sector scoring the top grade of A - GlaxoSmithKline, Merck & Company, Novartis, Roche Holding and Sanofi. One of the reasons for the high number of As is that this sector has a relatively lower risk profile compared with most others. Having said that, Pfizer only scores a C so investors should treat the company as one that is less adept at managing its sustainability risks than its peer companies and therefore it is at heightened risk of suffering financial losses as a result of sustainability risks.

## Improvers and decliners

The majority of the high profile large companies in the table above have maintained a consistent grade across the 2012 – 2013 reporting years. This demonstrates that the Global Sustainability Ratings are not subject to wide fluctuations, an important feature for sustaining low portfolio turnover. It also verifies that addressing sustainability challenges can take considerable time; the robust methodology behind the Global Sustainability Ratings assessment ensures that companies are implementing real improvements before they can benefit from an upgrade. When there are significant changes in the way that a company manages its sustainability risks then there is a change in score.

[3] http://www.forbes.com/sites/russellflannery/2012/09/05/thousands-of-chinese-students-forced-to-work-on-new-iphone-5-chinese-media-reports/

This year there are five companies that have gone up a grade and two that have gone down, as detailed in the table below.

## *Improvement*

| Company | Country | Sector | 2013 | 2012 |
|---|---|---|---|---|
| HSBC Holdings | UK | Banks | B | C |
| Commonwealth Bank of Australia | Australia | Banks | C | D |
| Nestle | Switzerland | Food Producers | B | C |
| Merck & Company | USA | Pharmaceuticals & Biotechnology | A | B |
| Qualcomm | USA | Technology Hardware & Equipment | C | D |

## *Deterioration:*

| Company | Country | Sector | 2013 | 2012 |
|---|---|---|---|---|
| J P Morgan Chase & Co. | USA | Banks | D | C |
| Samsung Electronics | South Korea | Technology Hardware & Equipment | D | C |

## Analysis of grade changes:

## *Improved grades:*

### HSBC Holdings

The Company has made improvements to the way that it manages its waste. HSBC has improved its performance in bribery reporting so that it now provides details on non-compliance and breaches of its bribery policy and non-compliance with money-laundering and sanctions laws.

### Commonwealth Bank of Australia

The Company has shown significant improvement in its environmental performance, particularly around the issue of climate change. Commonwealth Bank of Australia has seen improved assessment of its customer relations performance as it now systematically monitors its relationship with its customers. The Company can point to improvements in customer satisfaction survey scores.

### Nestle

Both environmental reporting and performance have improved for Nestle, particularly around the way it manages its climate change impacts and waste. The Company has also introduced a company-wide biodiversity action plan. In the area of human rights Nestle has collaborated with the Danish Institute for Human Rights to conduct social impact assessments in countries in which it operates with a high human rights risk including Nigeria, Angola and Sri Lanka. The company has developed action plans in response to the findings of the assessments.

### Merck & Company

Environmental management by the Company has improved, with it now setting quantitative targets and objectives for all key areas. In the area of job security the Company has implemented a procedure to minimise compulsory redundancies. Merck & Company has also been awarded a higher score for its community involvement as it has disclosed that its charitable donations exceed 0.5% of pre-tax profits.

### Qualcomm

The Company has improved its environmental policy so that all the key issues for the sector are covered and there is responsibility at Board level for environmental impacts. The company now provides quantitative data on all key issues and reports on environmental sustainability. Qualcomm has improved its management of bribery risk by implementing a policy prohibiting giving or receiving bribes and restricting facilitation payments and the giving or receiving of gifts. The Company also administers employee training in bribery policy compliance and carries out bribery risk assessments.

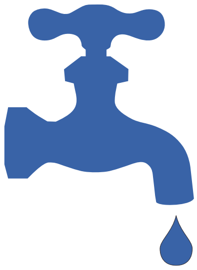
## *Deteriorating grades:*

### JP Morgan

The Company has seen a sharp decline in its environmental management score as the company no longer outlines its full environmental management system, provides details of non-compliance, fines, prosecutions or accidents, engages in stakeholder dialogue or has external verification of its environmental management system. In terms of governance the number of women on the board has dropped below 20%. The decline in grade can also be partially attributed to the fact that other companies in the Banks sector have improved their management of sustainability risks compared to JP Morgan.

### Samsung Electronics

The Company has been the subject of allegations in 2012 that underage workers have been found working for one of its suppliers in Guangdong in China. This breach of the International Labour Organization’s convention on child labour has been assessed by EIRIS as high impact and, as such, it has had a significant negative impact upon the Company’s Global Sustainability Ratings score.



# Spotlight on Water Impact

All businesses need water in one form or another, either through direct consumption, supply chain water use, or water use required during the life cycle of the goods produced. Water use has been growing at more than twice the rate of population increase in the last century, and although there is no global water scarcity as such, an increasing number of regions are chronically short of water. By 2025, the Food and Agriculture Organization of the United Nations estimates that almost 2 billion people will be living in countries with absolute water scarcity, and two-thirds of them could be under water stress conditions.[4]

Looking to the future EIRIS has identified a key sustainability risk around water management. Rapid industrialisation, pollution, and increasing agricultural use all contribute to worldwide water stress. Companies that have a significant water impact will need to demonstrate good management of water resources and the implementation of long-term solutions to water scarcity issues in their value chains.

Given the developing importance of management responses to water risks we will be giving an increasing weight to this indicator in future versions of the EIRIS Global Sustainability Ratings.

Water is an interesting case study because it overlaps with a number of other key sustainability themes. Climate change is likely to contribute to water stress in some regions as changes in weather patterns interfere with rainy seasons. In terms of impact, water stress is likely to lead to issues around human rights due to potential conflicts over access to water resources. Increasing demand for water will lead to negative impacts upon biodiversity and food production as water scarcity increases.

There are a number of risks for companies associated with water that investors need to be aware of. In general there are five categories of risk:

1. **Physical risk:**
   Risk associated with the competing demands for water, including water quality (e.g. agriculture, industrial, domestic). In water scarce regions the increasing demand for water use may result in water cuts during periods of water scarcity.

2. **Reputational risk:**
   In particular in water stressed regions where business demand for water is perceived to be in clear competition with domestic use.

3. **Economic risk:**
   The potential for water pricing regimes to be introduced in areas of scarcity.

4. **Regulatory risk:**
   As populations grow, where domestic supplies are at risk, governments may regulate access to water. This can result in the loss of licence to operate when businesses' use of water competes with the water needs of local communities.

5. **Political/geographical risk:**
   There is a risk that in water stressed regions conflict over water resources could emerge. Embedded water could also become an issue with government tariffs placed on the export of goods that require significant water input into their production, such as agricultural goods.

When assessing how well companies manage their water risk EIRIS focuses on a company's management response to the challenges of water risks in their business sector and geographical region, in particular, addressing the management of operational water use and performance disclosure, including supply chain and product water use where relevant.

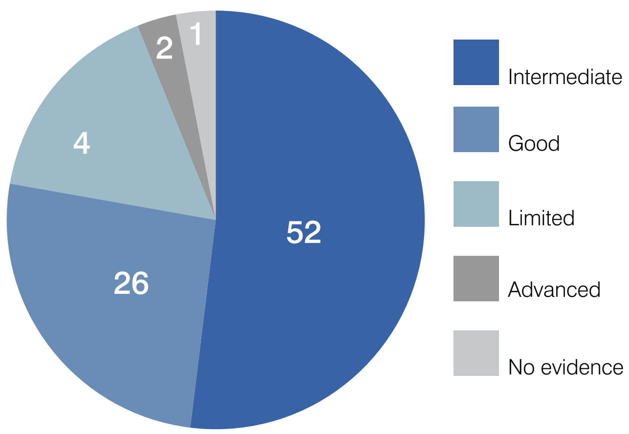
[4] http://www.un.org/waterforlifedecade/scarcity.shtml

For its water assessment EIRIS examines company responses in the following areas:

- policy and governance, such as whether there is senior responsibility for water management
- management and strategy, for example are there long term strategic goals linked to water use reduction?
- disclosure in relation to data like absolute water usage and trend analysis, and
- performance and innovation, including the use of technology and innovation to reduce operational water use.

The chart[5] below shows the performance of the companies from the list of 50 mega cap companies that have EIRIS water assessments due to their risk profile. Around a third of companies are assessed as having the highest grades in their Water Management response, which indicates that they are doing well at managing their water risks. On the negative side there are nearly a fifth of companies assessed as having the bottom grades in their water management responses. These are the companies that represent increased risks to investors in the area of water management.

Water Management Response %




[5] EIRIS water management assessments as at 31st May 2013

Investors should be engaging with companies to promote best practice in water management. There are companies in high water risk sectors such as Apparel Retailers, Supermarkets and Printing and Newspapers that are proactively tackling their water risk and thereby reducing the likelihood of financial loss as a result of water issues. Below are a set of initiatives by companies that represent best practice in the effective management of their water risks in sectors with a high water impact.

**1 Inditex |**
*Apparel Retailers* | Spain
The Company, whose brands include the clothing chain Zara, has a water strategy that contains the measurement and management of the company's water footprint, the implementation of master plans for audits and diagnostics, plans to reduce and optimise water consumption, and sensitisation and training on the issue for staff.

**1 Marks & Spencer Group |**
*Supermarkets* | UK
The Company has provided details on several corrective action plans, as part of the Plan A scheme, to mitigate its identified water risks. These include helping its food factories to develop and publish best practice guides on effluent recycling and water efficiency. It has installed water efficient fittings in its offices and stores and measures its water use at many locations.

**3 Reed Elsevier NV |**
*Printing & Newspapers* | Netherlands
The Company's Annual Incentive Plan includes performance targets specifically linked to Key Performance Objectives (KPO's) in sustainability. These are attributed to relevant directors rather than across the board as a whole and specifically include water management.

**4 Hennes & Mauritz |**
Apparel Retailers | Sweden
The Company demonstrates public policy leadership by participating in programmes that aim to improve the environmental performance of fabric producers. The Company also joined the Water Disclosure Working Group in 2010, the group aims for the harmonisation of existing and emerging corporate water disclosure initiatives. The Company has also worked with the Better Cotton Initiative (BCI) on a programme to reduce the environmental impact of cotton by using less water.

# Conclusions

For companies to be considered truly sustainable, they need to be addressing a wide range of material ESG issues that can play a part in realising sustainability, just one of which we have drilled into in this paper looking at water. While some companies are considered to be leaders in one particular area of sustainability (for example, environmental sustainability) they may actually be demonstrating poor performance in another area, such as social practices in the supply chain, which could leave the company's brand vulnerable to reputational risks (like the recent disaster in Bangladesh's clothing manufacturers). Companies should therefore be able to recognise that there are many sustainability issues that exist across each of the environmental, social and governance areas, and look to identify those which are relevant to their business activities so that appropriate management practices of these issues can be put in place.

In addition, companies need to ensure that their sustainability efforts do not just focus on specific areas that might be important to one particular stakeholder group; by taking a more diversified approach and responding to all the material ESG issues they face, they will be able to demonstrate their leadership in tackling these issues and thus creating a longer-term competitive advantage for the business overall. Similarly, investors, as owners of companies, can work with company management to ensure that they are abreast of the full range of ESG issues that investors see as relevant to the business, through dialogue and engagement with the company.

However, actions speak louder than words, so dialogue alone is not sufficient. As a next step, investors should be holding company management to account on the progression of their management and disclosure of the risks arising from these issues over time. This includes demanding more integrated reporting from companies to aid further integration of the ESG issues into investment analysis. Investors should also expect to see company management increasingly look to incorporate financially material sustainability risks and, of equal importance, opportunities into their forward looking business strategy overall, rather than just treating ESG as a standalone consideration.

# Using the EIRIS Sustainability Ratings

Whether it is through specific portfolio construction with ESG factors or themes in mind, wider integration of ESG risks and opportunities into the investment process, company engagement or indeed a combination of these approaches, investors can use the EIRIS Global Sustainability Ratings research to assess the longer-term sustainability prospects of the companies they invest in.

EIRIS Global Sustainability Ratings research offers investors the opportunity to compare companies on their sustainability performance across sector, country or region, on a combination of factors identified through EIRIS' thorough research approach and extensive stakeholder consultation. For example, the ratings can help with identifying the companies that could be considered best-in-class, or potential cases of concern, and therefore maybe suitable for investor engagement, as well as highlighting the key ESG issues that investors should focus on and use as a framework for dialogue with the company. Similarly, in an integration approach, the simple A to E Sustainability Ratings can easily be overlaid across existing investment processes (e.g. by informing either the start or end of the stock selection process), or even integrated into the underlying valuation models by analysts. As evidenced in the analysis provided in this report on how some of the largest companies globally have performed in terms of sustainability over the last year, the robust methodology behind EIRIS' Sustainability Ratings ensures that the grades reflect significant yet measurable performance, thus avoiding unnecessary churn in portfolios around upgrades or downgrades. EIRIS can offer investors advice and consultation on how best to incorporate the Global Sustainability Ratings into their specific investment approach.

Sustainability should be on the agenda for all investors, but it is the end investors or asset owners who are exposed to the real financial risks related to long-term sustainability challenges. It is therefore essential that asset owners are also aware of the sustainability risks and opportunities within their portfolios, whether they are internally or externally managed, and they should verify the extent to which their existing asset manager's strategy pays attention to these factors on an ongoing basis. To support both asset owners and asset managers with this, EIRIS offers a dedicated portfolio monitoring service based on the Sustainability Ratings assessments, providing aggregate views of how the portfolio is performing in terms of sustainability at the stock and sector levels (including identifying underperforming stocks with high risks), as well as comparing sustainability performance across a range of portfolios.

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# About EIRIS

EIRIS is a leading global provider of independent, global research into the environmental, social and governance (ESG) and ethical performance of companies. With almost 30 years' experience of conducting research and promoting responsible investment strategies. EIRIS now provides services to more than 150 asset owners and asset managers globally. EIRIS works with clients to create their own ESG ratings and rankings, to engage with companies and to create specific funds for their clients. EIRIS has a multinational team of over 60 staff in London, together with offices in Boston, Washington, D.C., Paris and Gothenburg. Additionally EIRIS has a global platform of research partners which includes research organisations in Australia, Germany, Israel, Mexico, South Africa, Spain and South Korea.

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