Schroders
Modern Slavery: Consumer companies exposed to increasing regulation

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MODERN SLAVERY: CONSUMER COMPANIES EXPOSED TO INCREASING REGULATION

We believe the recently implemented UK Modern Slavery Act (2015) reflects a broader trend of increased supply chain regulation which requires companies to assume more responsibility for, and provide greater transparency on, working conditions along their supply chains. The threat of fines is likely to be less important than brand impacts if weaknesses become apparent. We expect these pressures to augment the on-shoring and supply chain consolidation that is already being seen in a variety of industries today. Those companies that are further advanced in assessing supply chain strategies, and that have closer supplier relationships and comprehensive supply chain monitoring systems in place, are likely to be least exposed as the spotlight becomes brighter.

HIDDEN HUMAN RIGHTS RISKS

It is estimated that there are 45.8 million slaves in the world today, many of which may be indirectly employed in the supply chains of multinational companies. A recent example of this is the extensive slavery that was uncovered in 2015 in the Thai fishing industry, a supplier of many global food producers and retailers.

Figure 1. Estimated number of people living in slavery worldwide in 2015

![Image of world map showing estimated number of slaves in different countries.]


The definition of modern slavery encompasses a range of human rights abuses from forced labour (where people are made to work under the threat of violence or their passports are withheld from them), bonded labour (where people pay fees for the right to work and are then made to work in order to pay off the debt) and human trafficking, to servitude and child labour.

RISING REGULATORY PRESSURE

Companies are now facing increasing regulation as governments try to tackle this large-scale human rights issue. We believe this is part of a broader structural trend whereby governments are moving towards taking a more active and demanding role in regulating companies’ behaviour, reflecting a shift in social views of the corporate sector that has accelerated post the 2008 global financial crisis. Since 2010 and the launch of the California Transparency Supply Chain Act we have seen a raft of new regulations from the UK (see our later section on the investment impact of the UK’s Modern Slavery Act) and the EU, as well as proposed regulation at the federal level in the US.

Although the scale of modern slavery and the increased social and political awareness of the problem are key drivers behind greater government scrutiny, the complexity of supply chains and the challenge this poses to tackling the issue are also significant factors. The number of direct suppliers reported by companies varies hugely depending on sub-sector and can range from tens of thousands to hundreds of thousands. For example, US tobacco company, Phillip Morris\(^3\) reports that it sources its tobacco leaf from 450,000 farms. Even at this scale, most companies have monitoring systems in place to communicate supplier policies and conduct audits, but they often only cover tier one suppliers at the top of the value chain.

However, it is the suppliers several tiers down the value chain that pose the greatest slavery risk and this is where transparency and influence is weakest. A survey conducted by Deloitte\(^4\) with company CEOs, shows a disconnect between the importance managers attach to supply chain risk and how well they think they are managing those risks. The recent slavery case uncovered in the Thai fishing industry is a prime example of this. In this case, it was the fishing boats catching the small fish used to produce fishmeal, which is then used to catch shrimp, which were alleged to be using slave labour. Figure 2 demonstrates the complexity of the supply chain tiers in the Thai fishing industry. Although the slavery was discovered so far down the value chain, it still caused disruption to many of the retailers procuring the shrimp. The case has even resulted in litigation against CostCo\(^5\) and Nestle.

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2 http://www.legislation.gov.uk/ukpga/2015/30/introduction/enacted
Modern slavery matters to investors, as many companies held in existing portfolios will be required to demonstrate effective supply chain monitoring in order to comply with new regulations. The UK’s 2015 Modern Slavery Act requires compliance by any company operating in the UK with a global turnover greater than £36 million (section 54). This involves:

1. An anti-slavery statement published on a company’s homepage and signed off by the board or senior management.

2. Reporting and disclosure that demonstrates efforts to mitigate modern slavery within the company and along its supply chain. The UK Home Office has published a practical reporting guide that highlights six key areas that companies should report on.

The timeline for mandatory disclosure is six months after the publication of a company’s annual reports and accounts. This applies to companies that published annual reports after 31 March 2016 so the earliest mandatory disclosures will be made public from October 2016.


CONSUMER SECTORS MOST AT RISK

From our own research, we believe that the consumer sectors are the most at risk of exposure to modern slavery. Specifically, it is the food producers, retailers, apparel, tobacco and consumer electronics firms that are the most vulnerable. This is driven by the extent to which manufacturing is outsourced and the types of goods that these companies source. High risk goods include rice, spices, tea, coffee and cotton.

As the non-governmental organisation (NGO) Know the Chain has recently published a detailed analysis into the consumer electronics sector, our proprietary analysis focused on the four remaining consumer sectors (food producers, retailers, apparel and tobacco) where investors have less visibility on slavery risk. At the time of writing, only 75 companies have voluntarily issued a modern slavery statement, most of which are small cap or private companies. Analysis conducted by several NGOs on these voluntary disclosures revealed that only nine statements complied with the requirements of the Act. In the absence of modern slavery statements, we conducted our own research to create a proxy for the statements. We analysed company practices and management systems, and mapped these against risk to slavery along the supply chain. The methodology we used is as follows.

Know the Chain: A benchmark on labour practices in the ICT industry

KnowtheChain.org and Sustainalytics looked at 20 companies in the information and communications technology (ICT) sector. The companies were evaluated on governance, traceability, purchasing practices, recruitment, worker voice, monitoring and remedy. While the scores ranged from 0% to 72%, the average score was only 39%, suggesting that many companies still lag best practice. The weakest areas were recruitment practices, freedom of association and remedy. Some positive practices were demonstrated; for example, companies are looking beyond tier one suppliers and half of companies reviewed have banned recruitment fees. The top three companies were HP, Apple and Intel.


1. Supply chain management

We looked at the six disclosure areas highlighted in the Modern Slavery Disclosure guidance published by the UK Home Office (see figure alongside).

We then used data from the Business and Human Rights Resource Centre as a proxy for each of the six criteria, as well as our own knowledge of the companies from prior assessments and engagements. We used this to calculate a management score, ranging from 0 (nothing disclosed, poor practice) to a top score of 8 (strong disclosure, reflecting best practice).

7 https://knowthechain.org/the-issue/
9 https://business-humanrights.org/
2. Slavery risk through commodity and exported goods exposure
We used the Global Slavery Index for prevalence scores across 170 countries and cross-referenced these against individual commodities and exported goods at a country level. We identified which commodities and exported goods individual companies were most exposed to through annual reports to calculate a risk exposure score. We then mapped the management score from point 1 against this exposure score to identify companies that are at risk from failing to comply with the new regulation and may need to invest more in supply chain monitoring.

3. Results
Our analysis helped us to understand the risks across the consumer sector. We found that companies operating in the food products and tobacco categories are the most vulnerable as they produce agricultural products or source raw materials from countries where modern slavery risk is high. Apparel firms are also susceptible to the risk of modern slavery through their sourcing of cotton, leather and ready-made garments while restaurants are the least likely to be exposed.

Figure 3: Schroders risk map: consumer sector

Source: Schroders, August 2016. For illustrative purposes only.

Next steps: engagement
As active owners, we will engage with the companies identified as high risk in our risk map. We will contact companies with low management scores (below 3) as well as companies with the highest risk exposure and medium management scores (between 3 and 5). Our aim is to encourage these companies to provide more transparency and reassurance that they are identifying and mitigating potential risks along their supply chains. Better disclosure will then help us to move beyond the use of proxy data to better inform our investment assumptions and quantify potential risks and opportunities across our clients’ portfolios.

UK Modern Slavery Act: the investment impact
Although our research focused primarily on consumer companies, it is not only these firms that will be impacted by increased regulatory pressure. We looked more broadly across the corporate sector and identified three investment implications of the Modern Slavery Act, which are summarised below.

1. Efficiency gains
For many firms, the first place cost efficiencies are achieved is with their top tier suppliers. However, we believe that the requirement for better visibility further down the supply chain, where transparency is weakest, may be a catalyst for increased efficiency gains among lower tiers. For example, following the exposure of the labour abuses in the Thai fishing industry, Tesco has a much better understanding of the...
lower tiers of its supply chain. Our engagement meetings with the company confirmed that management have been able to apply the lessons learned from this experience across its broader supply chain to reduce risk.

Elsewhere, after the Rana Plaza factory collapse in Bangladesh in 2013, in which scores of workers were killed, many apparel retailers such as Associated British Foods (ABF) hired structural engineers to check the safety of the factories they source from. According to the company, these factories are now safer than before and there is a lower probability of further disruption. ABF’s sector peer H&M is now also working more closely with factories in Bangladesh and has reportedly achieved a reduction in employee turnover and is successfully up-skilling workers. The company can now source increasingly complex garments such as suits from Bangladesh (in the past it had to source such items from more expensive markets given a lack of skill in Bangladeshi factories).

These incidents are not just triggering change at an individual company level; they are prompting an industry-wide response. When working together, companies can achieve even greater efficiencies. For example, the Accord on Fire and Building Safety in Bangladesh11, signed by over 200 retailers and apparel companies, has resulted in the closure of 18 factories deemed unsafe, which has reduced risk for leading companies.

2. Increasing costs for laggards

We believe that companies with leading supply chain practices are better placed to respond to regulation but laggards will need to invest more in supply chain monitoring to keep up with rising standards. This may materialise through higher capital and operational expenditure. Within the tobacco sector for example, there is a 5% difference in the cost of goods sold depending on whether a firm uses a direct or indirect sourcing model. A large proportion of this additional 5% for direct sourcing can be attributed to the cost of supply chain training, auditing and monitoring. The extent to which these costs increase and impact margins may be determined by a company’s position in the value chain and the sub-sector in which it operates. For example, a firm with strong brand power and scale may be able to pass these increased costs down the value chain onto its end consumers, but a smaller company may have to absorb these costs themselves.

3. Catalyst for supply chain consolidation

We also believe that greater regulatory scrutiny could be a catalyst for supply chain consolidation through vertical integration and result in an acceleration of the on-shoring trend. Recent examples of this include luxury goods companies such as Chanel, which is integrating silk suppliers into its operations12, and Kering, which is acquiring tanneries13 to mitigate risk. Footwear company Adidas has recently announced that it is moving some of its footwear manufacturing from suppliers in Vietnam back to Germany, to bring production in-house14.

11 http://bangladeshaccord.org
While these vertical integration efforts may increase capital spending in the short term, they could also increase operational efficiencies and improve product quality. Such moves could also serve to offset the dual risks of continued wage inflation across Asia and the breaching of a growing number of regulations in this space. It is for this reason that this new Modern Slavery Act has been dubbed a catalyst for a “race to the top”, reversing the supply chain trends we have witnessed since the late 1980s.

**Thematic trend:** Governments mandate to regulate

**Increasing cost of supply chain monitoring**

**Supply chain consolidations and onshoring**

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lower risk and greater efficiencies

Source: Schroders.

CONCLUSION

As the spotlight on slavery becomes brighter, it will be those firms that are further advanced in assessing supply chain strategies, with close supplier relationships and comprehensive supply chain monitoring systems in place, that are likely to be least vulnerable to the risk of slavery. While it is too early to assess the scale of compliance with the UK’s Modern Slavery Act, we believe that our proprietary analysis provides a good indication of whether companies are well or poorly placed to respond. As active owners we will engage with the companies highlighted to encourage them to strengthen their practices.