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ESG Integration in Consumer Sectors

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In a previous post, my colleague explained how the William Blair Global Equity team's integration of environmental, social, and governance (ESG) considerations has evolved over the past few years, and now I'd like to look at some case studies in the consumer staples and discretionary sectors, where key ESG drivers include governance, product safety, supply chain oversight, and eco-friendly product innovation.

To understand how these factors are affecting companies we research, we assess relevant risks and opportunities as we perform our due diligence. Third-party ESG ratings are helpful in questioning or confirming what we uncover, but we try to understand what factors, both positive and negative, influenced the ESG rating, and we seek to identify the negatives and also false negatives. Doing this, we have at times found companies with poor ESG ratings despite a track record of generating value for shareholders. We provide a few examples below.

U.S. Food and Staples Retailer

One of the best global retailers in the food space has generated outstanding shareholder returns over the past 20 years receives the lowest possible ESG rating from MSCI.

In seeking to identify the drivers of that rating, we found that the largest was social impact, primarily in terms of food safety. This is an inherent problem in food production and retailing because such companies have large global supply chains. This company had a problem a few years prior when a food poisoning outbreak was linked to shrimp it sourced from Thailand. As a result, MSCI scored this company poorly for social impact.

We, on the other hand, try to identify and differentiate the structural (versus temporary) problem. We also look not just at the issue, but how the company responds. In this case, the problem was resolved, and the company took measures to ensure that food safety along its supply chain is well identified and controlled—positives, in our view.

Filipino Packaged Food Company

Another example is a large Filipino packaged food company that has a poor ESG rating primarily because of its significant family ownership, which lowered its corporate governance score.

We do not automatically assume corporate governance is poor just because a company has high family ownership: such ownership is not uncommon for emerging market companies, and even companies in certain developed markets, such as Japan.

We look at the company's track record instead. Because there is a continuity of policies, family ownership can be positive, as long as the family owners' interests align with shareholders' interests, and the company is transparent about capital allocation and management decisions.

To better understand this company's ESG attributes, we reached out to management and highlighted some of the ESG issues identified by MSCI. One was overboarding, which refers to directors sitting on a large number of boards, compromising their ability to fulfil their duties. Applying MSCI's governance ratings methodology, it was black and white: If there's overboarding, it's bad. This isn't meant to criticize the methodology, but demonstrate the importance of not relying exclusively on ratings data to make decisions.

As it turns out, that overboarding stemmed from the family's ownership of many other companies in the Philippines. It is a typical Filipino conglomerate, so directors on the company's board had to sit on the boards of other companies in the conglomerate.

As a result of our discussion, the company decided to step up its ESG efforts, going so far as to hire a third-party consultant who we engaged with to provide feedback on governance, as well as relevant social and environmental factors. We find this to be positive, not only from an investment perspective, but also because our integration objectives include helping companies improve in regard to their ESG measures.

German Athletic Apparel and Footwear Company

Lastly, a global athletic apparel and footwear company had constantly improved ESG ratings on the environmental and social side because many of its products are manufactured in Asia with oil-related derivatives.

This company recognized the problem and took active steps to use more recyclable materials in its products—and in seeking to improve its environmental risk profile, this company actually innovated its product line. Products made with the recycled fabric can be sold at a higher price point because consumers want more sustainable products.

This is a good example of how ESG provides benefits from both an investment and operational perspective. Over time, this company's steps also improved its social risk profile by working to improve its Asian supply chain. Standards there used to be low in terms of workplace safety, and because of this company's efforts, they are improving.

A Bottom-Up Perspective

These examples illustrate how we look at ESG factors from a bottom-up perspective, incorporating both third-party ratings and our own due diligence (which usually includes conversations with both a company and its vendors) to ensure that the quality of the company and returns on capital are up to our standard when we invest.

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