PRI Principles for Responsible Investment

MANAGING ESG RISK IN THE SUPPLY CHAINS OF PRIVATE COMPANIES AND ASSETS

UNEP FINANCE INITIATIVE | United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1 **We will incorporate ESG issues into investment analysis and decision-making processes.**

2 **We will be active owners and incorporate ESG issues into our ownership policies and practices.**

3 **We will seek appropriate disclosure on ESG issues by the entities in which we invest.**

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.

PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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- Barbara Bijelic, Legal Expert - Responsible Business Conduct, OECD
- Måns Carlsson-Sweeny, Head of ESG Research, Ausbil Investment Management

WHO SHOULD READ THIS REPORT?

This guide is primarily intended for direct investors and general partners (GPs) investing in private markets.

It aims to empower private equity and real asset investors to improve the risk profile of their portfolios and maximise their returns by investing in companies that manage their supply chains effectively.

Limited partners (LPs) may also find it useful to better understand GPs' approaches to managing risk and opportunity within investee company supply chains. While the material is more relevant for private market investors, public market investors could also file resolutions for companies to investigate and report on their supply chains using the tools and questions in this guide.

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HELP US DEVELOP THIS PILOT FRAMEWORK INTO A TOOLKIT

Your comments are needed to help us refine this guide. Please email supply.chain@unpri.org with feedback and suggestions.

FOREWORD

The PRI helps its signatories to make progress on implementing the six Principles and incorporate environmental, social and governance (ESG) factors into investment and ownership decisions.

Considering ESG risk and opportunity in the supply chains of investee companies has traditionally been the elephant in the room, particularly in private markets where transparency, disclosure and company capacity to manage supply chains may be limited. Yet, the business case for effective management of ESG risk, including in the supply chain, is clear; the only way to guarantee peace of mind when managing risk to company value is to address the topic with investee companies.

This guide provides practical initial steps investors can take to assess and manage supply chain risk. Collectively, investors can be at the forefront of driving the management of ESG risks in the supply chain up the corporate agenda.

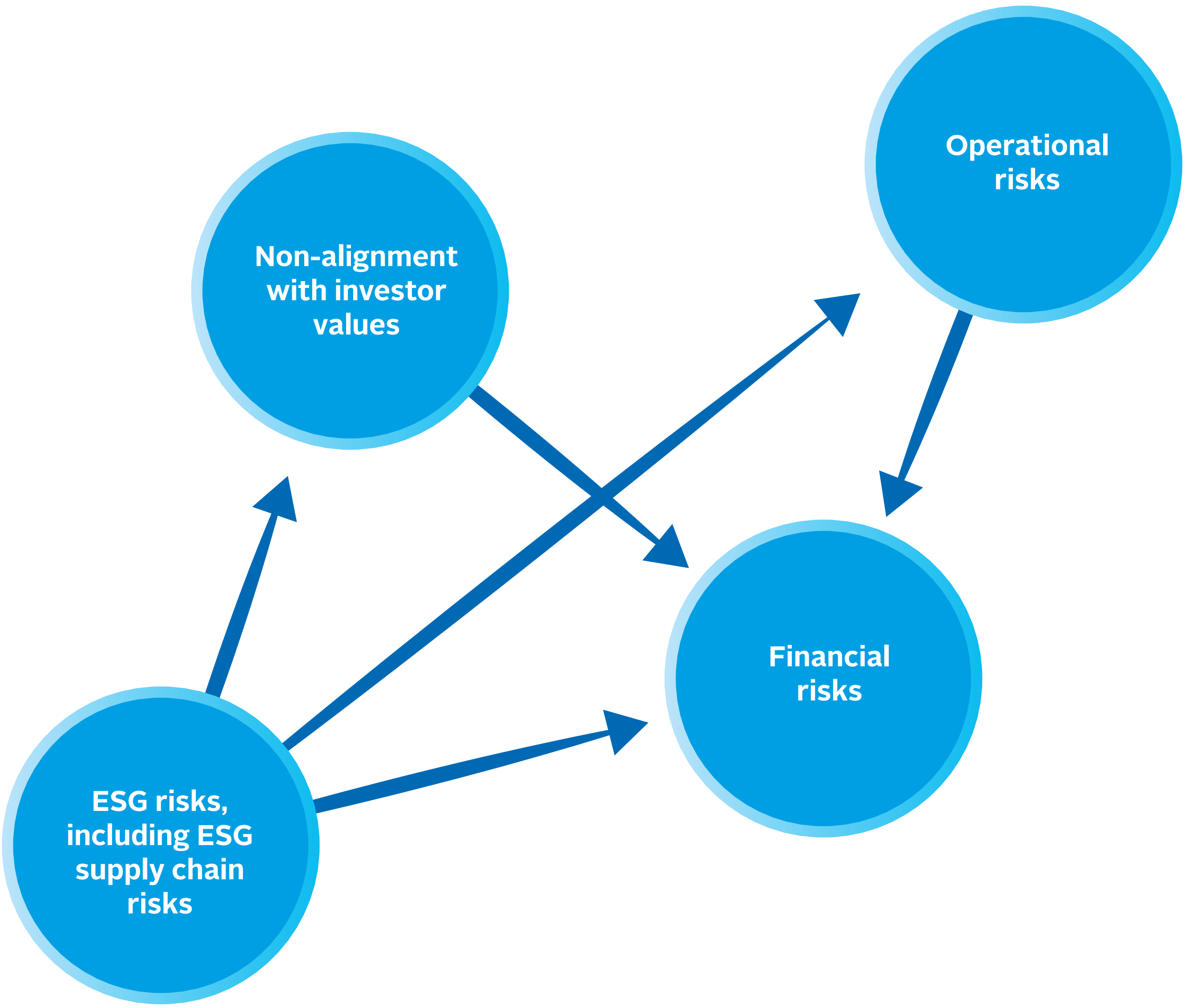
Fiona Reynolds,
Managing Director, PRI

INTRODUCTION: WHY ESG FACTORS IN THE SUPPLY CHAIN MATTER

Supply chains can be highly complex. They often span many countries and include multiple tiers, which are made more opaque by outsourcing and offshoring. They are also essential to the success of almost all businesses and can be a significant source of value creation and innovation.

As supply chains fall outside of a company's core operations, they expose them to hidden and uncontrollable risks typically driven by ESG factors, such as natural resource depletion, human rights abuses and corruption.

These issues can harm the reputations, operations and financial performance of businesses or assets owned by investors, as well as investors' own reputations and investment performance. Compliance with local regulation is rarely sufficient to meet stakeholder expectations (e.g. certain countries in which a supplier may operate may have less robust legal and regulatory standards than others).



MATERIAL IMPACTS FROM ESG RISK IN THE SUPPLY CHAIN

Seeking Alpha α

Two Rotten Meat and Deforestation Scandals Threaten JBS and BRF's IPOs

As reported by Chain Reaction Research, JBS SA (OTCQX:JBSAY) (OTC:JBSAF), the world's biggest meatpacking company, halted beef...

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NEW YORK (Reuters) - Mattel Inc MAT.N posted a lower quarterly profit on Monday, missing Wall Street estimates, due to charges and disruptions from its recent global recalls of potentially harmful toys made in China. The maker of Barbie dolls and...

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REUTERS

Thai floods batter global electronics, auto supply chains

BANGKOK/ TOKYO (Reuters) – Manufacturers of car parts to computer hard drives are worst hit in Thailand and face a bleak key holiday selling season due to massive floods, which have shut down production. Japanese car makers...

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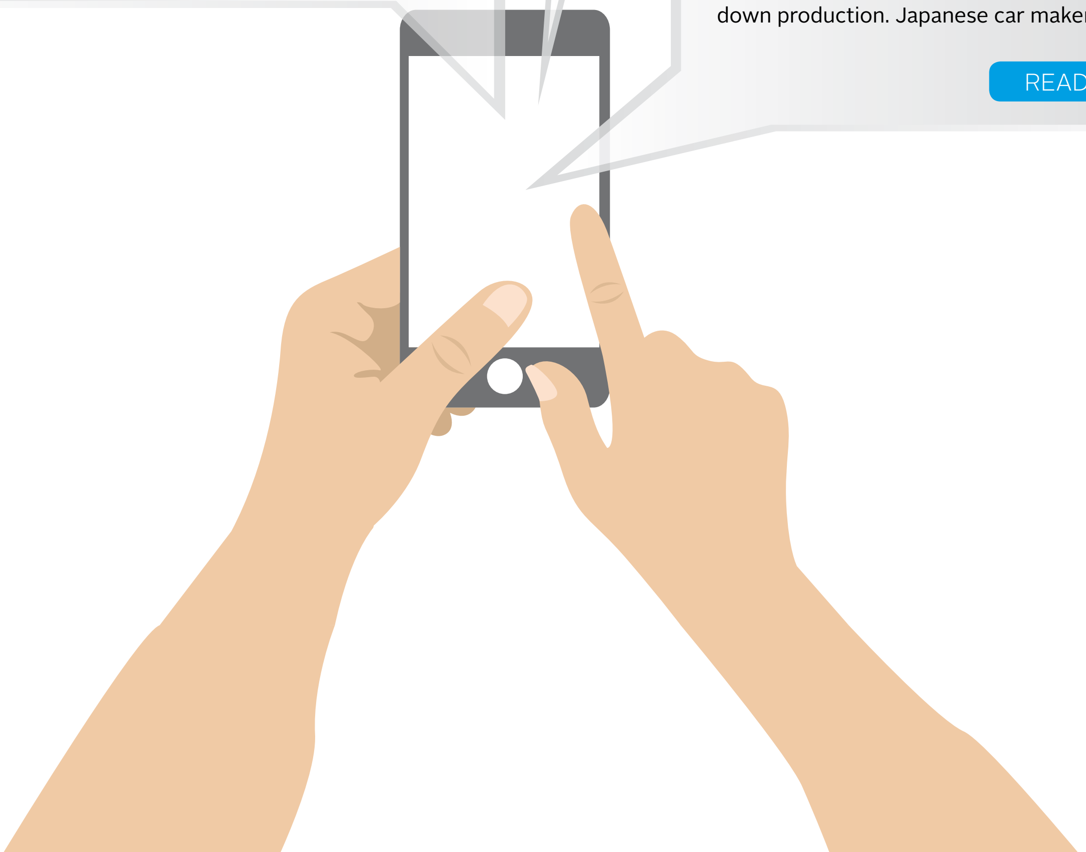
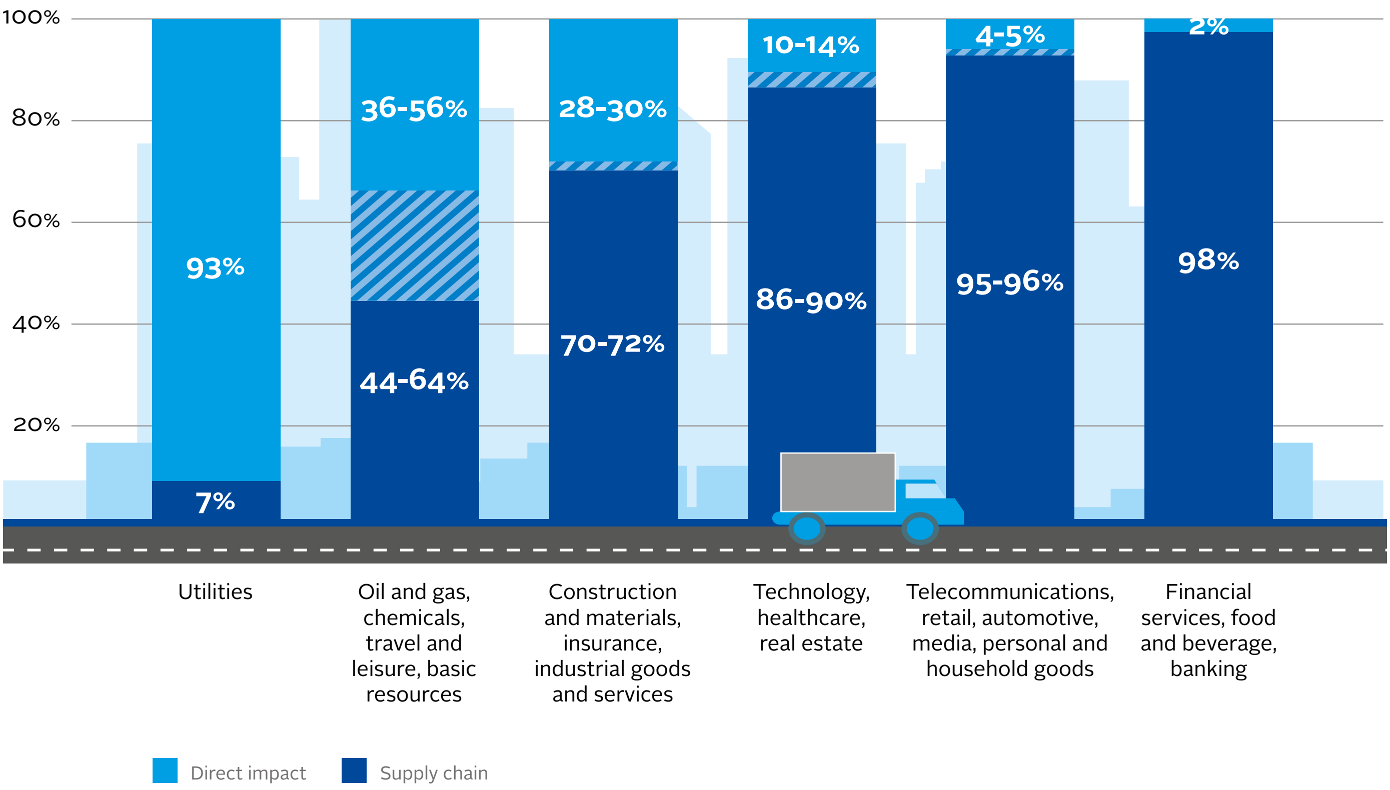


To add to the complexity of supply chains, they are heavily interdependent. As such, the relationship between products and services and ESG risk factors are intertwined across sectors and throughout every level of the supply chain.

Figure 1, from a study by environmental research firm Trucost, highlights the extent to which supply chains impact the environment compared to direct operations.

Figure 1 – Share of a sector's environmental impact located in the supply chain



This guide focuses on both external supply chain risks coming from third party suppliers and internal risks relating to supply chain management. The direct impacts on businesses can be felt in a number of ways:

- interruption of flow of materials, including raw materials or components;
- impact on delivery times with knock-on effects to customer satisfaction;
- poor financial management of the supplier leading to inability to supply goods on time;
- loss of social license to operate resulting from major reputational concerns linked to pollution, human rights abuses, corruption, etc.;
- increase in cost of materials as companies are forced to change their suppliers last minute.

For private market investors, managing ESG risks in the supply chain is of particular importance because:

- Private companies tend to be smaller than listed companies and so may have less stakeholder pressure to manage ESG risk in their supply chain from stakeholder pressure. They may also not have the same resources to adequately manage complex risks across multiple tiers in their supply chain.
- Private markets are relatively illiquid, so divestment to avoid reputational or other ESG-related issues may be a costly option – another reason for more detailed due diligence and engagement.

THE BENEFITS OF GOOD ESG RISK MANAGEMENT IN SUPPLY CHAINS

Managing ESG factors in supply chains brings both short-term and long-term financial benefits:

...TO OPERATING COMPANIES OR ASSETS...

- **Quicker response to emerging regulation or legal obligations** which incur supply chain responsibility (e.g. UK Modern Slavery Act, modern slavery legislation in the EU, environmental laws in China, increased enforcement of labour rights in China, EU Conflict Minerals Regulation, French multinational companies Duty of Care bill, etc.).
- **Protecting (social) license to operate** – avoiding loss of governmental contracts (government procurement is increasingly including ESG criteria), protecting human rights, avoiding corruption, avoiding the use of child labour, managing the use of controlled materials such as conflict minerals, etc.
- **Increased stakeholder confidence** – including investors, clients (if investee company is a supplier), customers, communities, civil society and non-governmental organisations, regulators, lenders, employees.
- Significant opportunity for investee company to **develop long-term, trusting partnerships** with their direct suppliers and to protect and/or enhance the relationship between their suppliers and their customers or end users.
- **A reduction in costs through better financial risk management** – i.e. minimising supply chain disruption (e.g. in relation to social unrest), fines, litigation, insurance premiums, replacing suppliers, etc.
- **Enhancing business continuity** – contract breach, product boycotts, supplier loss, capital flight, etc.

...AND TO INVESTORS...

- **Better alignment with internal responsible investment policies** and commitments which may reference specific corporate responsibility standards.
- **Alignment with internationally accepted best practices** – responsibility of investors/companies as defined by the UN Global Compact, the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.
- **Higher company revenue from increased labour and process productivity** – leaders in supply chain management can demonstrate a positive correlation between good management of labour rights and product quality, lead times and cost of goods sold.
- **Improved environmental performance of portfolio as a whole** e.g. less risk of pollution incidents, reduced environmental footprint (e.g. carbon, water, ecological), and increased efficiencies resulting in financial value creation opportunities.
- **Formal supply chain management procedures can make investee companies and assets more attractive** as investors look to exit.

ESG FACTORS IN SUPPLY CHAINS: RISING UP THE INVESTOR AGENDA

Businesses are increasingly expected to understand and manage their exposure to supply chain risks. Public awareness of supply chain issues continues to grow, with globally renowned companies increasingly under scrutiny to take action on major ESG issues among their suppliers. Rapid advances in technology are making it easier and less costly to monitor supply chains. For example, blockchain[1] and virtual reality (VR) technology could make it far simpler for large organisations to virtually visit their sites and trace upstream suppliers on the other side of the globe. In many sectors, risks are often far greater in the supply chain than in the investee company's direct operations. For those with a good understanding of their supply chain, this is a great opportunity. For others, it is getting harder to hide.

Companies are increasingly expected to understand and manage their exposure to supply chain risks. For those with a good understanding of their supply chain, this is a great opportunity. For others, it is getting harder to hide.

1 An incorruptible digital ledger of transactions.

2 The OECD guidance refer to Responsible Business Conduct (RBC) as a synonymous of ESG risks, although these risks should be identified as impacts on the society and environment and not just as risks to the investors themselves or their investee companies.

The implications extend to investors. The OECD's paper, [Responsible Business Conduct for Institutional Investors](), clarifies expectations of responsible business conduct for institutional investors under the OECD Guidelines for Multinational Enterprises. It states that the relationship between an investor and an investee company is different from the relationship between purchaser and supplier companies, but that the investor can seek to influence the responsible business conduct of the investee company through ownership. Even minority shareholders may be directly linked to adverse environmental and social impacts caused or contributed to by investee companies in their portfolios.

As a result, investors are expected to undertake ESG[2] risk-based due diligence and consider ESG risks in their investment processes. For LPs, this starts with including ESG risk in due diligence on the GP before making a commitment to the fund and including these risks in ongoing monitoring of the GP. For GPs and direct investors, this requires identifying ESG risks before the investment and monitoring them during the holding period. Investors are then expected to use their leverage with companies to influence them to prevent or mitigate adverse impacts.

Companies face significant commercial and physical challenges to managing risks throughout their supply chains, especially when they have multiple tiers. Investors rarely systematically or explicitly articulate their expectations for how investee companies should manage ESG risks and opportunities in their supply chains. Many companies are just beginning to develop the tools and practices needed to identify, engage with and manage these issues. Even best practice ESG risk management is generally limited to the operations of the investee company itself and does not encompass the multiple supply chain tiers on which it depends.

In seeking to manage risk within their portfolios, investors have an opportunity to help drive ESG factors in supply chain up the corporate agenda.

WHAT TO LOOK FOR

Given the implications of ESG issues arising in investee company supply chains, there are clear incentives for investors to engage those companies and manage the risks more effectively. Investors should ensure investee companies are:

- applying due diligence when identifying and managing ESG risks and opportunities with their direct suppliers of goods and services; and
- liaising with their direct suppliers to engage with their own direct goods and services suppliers (i.e. second tier suppliers to the investee companies), effectively creating a cascade of ESG management through the supply chain.

EXISTING RESOURCES

This guide has been created specifically for investors to align with the large number of existing initiatives focused on supply chain risk management. Some of the most commonly used resources relating to supply chains are listed below. To support this guide, the PRI is putting together a comprehensive map of supply chain resources relevant to investors.

- The UN Global Compact is a call to companies to align strategies and operations with universal principles on human rights, labour, environment and anti-corruption, and take actions that advance societal goals.
- The CDC ESG Toolkit for Fund Managers provides multiple ESG tools, including sector-profiles, ESG in the investment cycle and ESG management systems.
- The Global Reporting Initiative (GRI) has produced 36 standards which represent global best practice for companies to report publicly on a range of economic, environmental and social impacts, including procurement practices.
- The OECD study Responsible Business Conduct for Institutional Investors, outlines the due diligence processes that investors should apply in order to minimise adverse impacts associated with the environment, human and labour rights and corruption in investment portfolios.

> "Landing on 'not enough information to assess' is an insufficient due diligence conclusion. The conclusion should be that significant ESG risks may exist and that the deal team will assess in more depth immediately post-acquisition."
>
> Adam Heltzer, Partners Group

2 The OECD guidance refer to Responsible Business Conduct (RBC) as a synonymous of ESG risks, although these risks should be identified as impacts on the society and environment and not just as risks to the investors themselves or their investee companies.

CASE STUDY

JP MORGAN ASSET MANAGEMENT AND SONNEDIX

As a solar power producer, PV modules are arguably the most critical component of Sonnedix's business.

Sonnedix was asked by JPMAM to evaluate how, and to what degree, conflict minerals (specifically tantalum, tin, gold, and tungsten) are present in Sonnedix's supply chain and how this should be considered and addressed in its business.

Responsible mineral sourcing can help avoid both human rights abuses, as well as the contribution to conflict fuelled by the extraction and trade of minerals.

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CASE STUDY

MERIDIAM AND LISEA

Lisea, an investee company of French infrastructure investor Meridiam, must meet public authority environmental and social planning requirements to complete the Sud Europe Atlantique high-speed railway line between Tours and Bordeaux. The project must not only comply with local laws and regulations, but also with a number of ESG commitments and objectives set by Meridiam and the other Lisea stakeholders. However, during the construction phase, Lisea depends mostly on its first supplier, the EPC contractor, to deliver the project.

ESG concerns include the fact that the project footprint includes 11 Natura 2000 sites where more than 200 protected species can be found. Although mitigation and compensation measures for environmental impacts are contractual requirements, non-compliance of the supplier would have caused reputational damages to Lisea. In such an ecologically sensitive area, teaming up with a supplier with strong ESG credentials assured Lisea that mitigation measures would be implemented as planned and that stringent monitoring would be implemented.

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CASE STUDY

PARTNERS GROUP AND ACTION

In early 2014, Partners Group and Action management recognised the growing investment and reputational risk from not staying ahead of rising ethical standards in Action's supply chain.

Action subsequently commissioned an ethical sourcing "health check," to benchmark Action's performance relative to peers and industry best practice, pinpoint the areas of greatest risk, and prioritise intervention areas in its responsible sourcing strategy. This raised the need for action to establish a stronger ethical sourcing culture: the policies, vision and strategy from senior management that could signal the importance of the topic.

Following the health check, Action established an ethical sourcing policy and supplier code of conduct that outlined clearer expectations to suppliers than the brief, high-level language previously included in the standard terms and conditions. Action has now set its sights on the next phase of its ethical sourcing initiative. Priority next steps include developing a formal escalation process and a set interval for how often to reassess suppliers to monitor progress.

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CASE STUDY

ACTIS AND OSTRO ENERGY

One of the ESG challenges which was identified very early on was labour standards in the supply chain – specifically the working conditions on site for all workers, including sub-contractors. A monitoring site visit by the Actis RI team together with the Ostro Head of ESG identified gaps in working conditions and paved the way for the development of an improvement programme. Working collaboratively, Actis's RI team and Ostro developed standards for worker accommodation and labour conditions, as well as guidance regarding access to safe drinking water and sanitary facilities. The outcome was the Ostro Labour Accommodation Standards Policy, based on international best practice (drawing from IFC/EBRD guidance). Therefore, soon after Actis set up Ostro as a renewable energy platform, the company has ensured that the policy forms part of the legal agreement with contractors, and is therefore applied systematically across all projects.

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HOW TO ENGAGE WITH COMPANIES ON ESG SUPPLY CHAIN RISK

This section contains questions that investors can ask investee companies pre or post-investment. The questions focus on ESG risks and opportunities in the investee company's supply chain. It is also designed to encourage the investee company to develop appropriate monitoring procedures where they are lacking.

The list of suggested questions is not intended to be exhaustive, nor to replace existing due diligence frameworks, but rather to supplement them. Not every question will be relevant to every type of investee company or asset.

The questions cover:

- **company policies and processes** (ideally formal procedures) relating to identifying and managing ESG issues in the supply chain;
- **specific ESG** issues based on materiality to the investee company in question, and a deep-dive on these issues where necessary;
- **implementation and practice of ESG management** within the supply chain.

The questions are intentionally broad, allowing investors to focus on what they consider to be the most material ESG issues. Appropriate questions may change based on a number of factors including sector materiality, company practices and time horizons; for example, between development, construction and steady-state operations or over the life cycle of an infrastructure investment.

PRACTICAL CONSIDERATIONS FOR STARTING ENGAGEMENT

MOVING FROM INITIAL STAGES TO A MORE DEVELOPED APPROACH TO SUPPLY CHAIN RISK MANAGEMENT

With the nature of supply chain risks being difficult to address and resolve, it is important to begin the process of understanding and managing them instead of ignoring them. Rather than expecting best practice to exist and be achieved instantly, investors should aim to encourage companies' commitment to continued improvement as they move from initial stages of supply chain risk management to a more developed approach, as highlighted by Table 1 below.

Table 1 – Features of the starting point compared to a developed approach of supply chain ESG risk management

STARTING POINT FOR COMPANIES	DEVELOPED APPROACH FOR COMPANIES
▪ Limited visibility over supply chain. ▪ Transactional relationships with suppliers likely to have major emphasis on short-term cost resulting in the potential for reduced trust and loyalty. ▪ Conflicting interests between procurement and sustainability teams. ▪ Engagement with suppliers focused on audits. ▪ Limited collaboration with other stakeholders. ▪ Limited disclosure about supply chain standards and supplier details. ▪ Policies typically focus on legal compliance only.	▪ Mapped-out supply chain and encouragement of tier one suppliers to engage with those further down the chain. ▪ Rewarding suppliers that improve with more business and continually allowing them to invest in improvements with confidence. ▪ Streamlining of interests of procurement and sustainability teams. ▪ Strengthened relationships between company and suppliers, moving from auditing alone to more regular interaction. ▪ Confidential grievance mechanisms so that suppliers can voice any suspected ESG breaches anonymously. ▪ Openness and transparency of supplier base, including any challenges/issues identified. ▪ Seeking feedback and input from external stakeholders. ▪ Policies going beyond legal compliance alone.

An investor can obtain the following information as initial steps towards engaging on supply chain management with its relevant portfolio companies.

- What is the company's current visibility of their own supply chain?
- What is the current nature of relationships between the company and its suppliers?
- How is supply chain engagement managed between internal procurement and sustainability functions?
- To what extent does the company audit its supply chains?
- To what extent does the company collaborate with other stakeholders related to ESG issues?
- Which existing supply chain policies are in place?

PRIORITISING ACTION ON ESG RISKS AND OPPORTUNITIES IN THE SUPPLY CHAIN

Investors need to prioritise action and engagement on ESG risks and opportunities based on materiality to the company and, in the case of risks, the severity of the potential adverse impacts.

Investors should develop questions relevant to their own requirements and the nature of the investee company. This should be tailored rather than a check-box approach. There is no definitive list of right or wrong questions.

Figure 2 provides an example framework of issues, variables and references to use as a starting point.

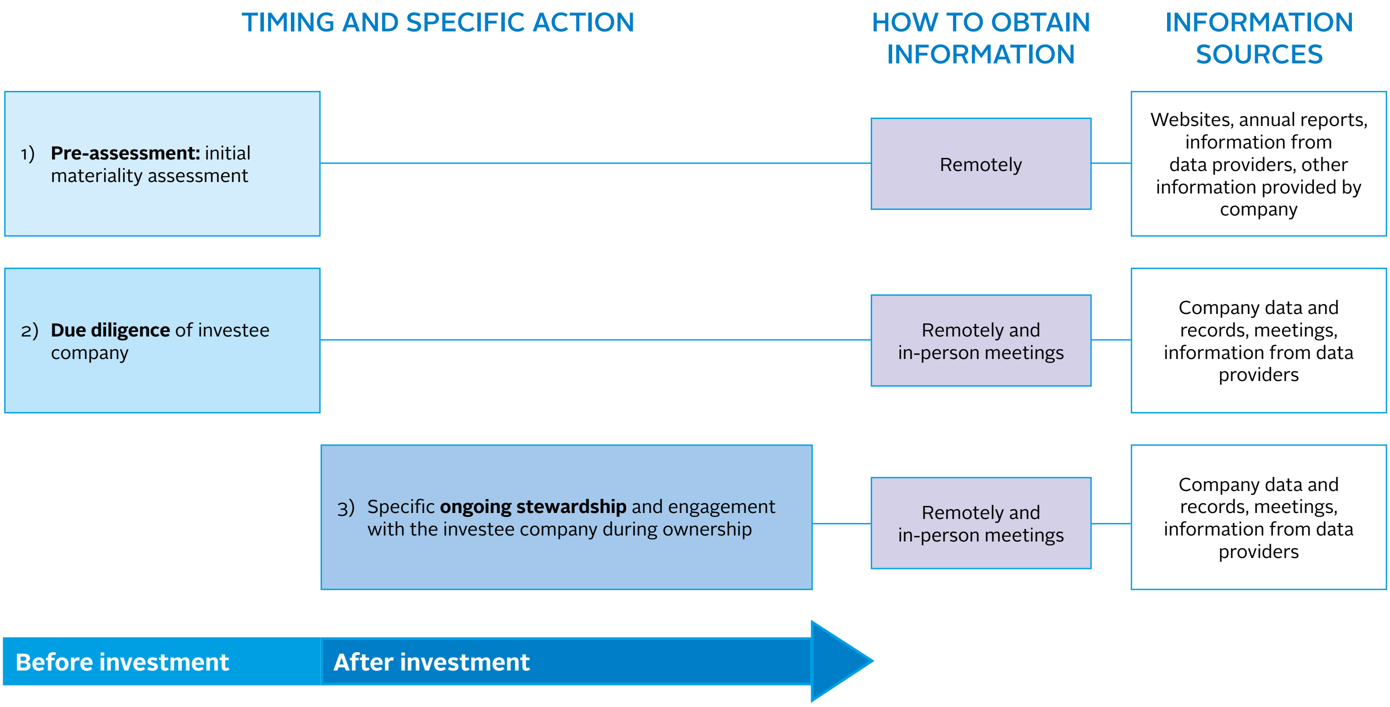
Figure 2 – Example framework for identifying and prioritising ESG risk and opportunity in the supply chain

Issues	Variables	Example reference sources
Geographical reach of the supply chain	OECD/non-OECD countries	OECD, Transparency International etc.
The **sector-specific materiality** of the ESG issues being managed	Human rights, labour practices, natural resources, biodiversity, waste and pollution, fair operating practices, consumer issues, community engagement and development, etc.	SASB, CDC sector profiles etc.
Nature of the supply chain	Fragmentation, complexity, continuity, market dynamics, etc.	Indicative sector averages (where available)
Size of the investee company	Small/medium/large	
Uniqueness/critical **nature of the products or services being provided**	High/medium/low	
Criticality of the investee company to its community	High/medium/low	
Length of the direct supplier's contract with the investee company	Time	
Contractual audit/cancellation rights of the investee company	Yes/no	
Dollar spending thresholds in procurement of goods and services	High/medium/low	
Aggregated ESG risk		

WHAT TO ASK AND WHEN

Which questions to ask depends on the stage of the investment process below (shown in Figure 3):

Figure 3 – When to engage on supply chain management



1. The **pre-assessment** will provide indicative measures and establish an understanding of the supply chain risks and opportunities specific to the potential investee company, before asking the company more detailed questions during the initial investment due diligence.
2. During **due diligence**, questions are likely to focus on basic governance issues, performance, and may provide red flags to inform the investment decision or produce a time-bound action plan to close performance gaps.
3. During **ongoing stewardship** and asset management, engagement on supply chain ESG risks is likely to be deeper to encourage performance improvements. Establishing goals with investee companies may be easier for majority shareholders and those holding board seats.

Co-investors should look to collaborate, wherever possible, to aggregate their influence over investee companies and streamline engagements to avoid reporting fatigue.

The questions proposed for due diligence (initial investment) and during ongoing ownership and stewardship (post investment) are addressed in the same questionnaire below.

> "Supply chain activities generally look relatively different during development, versus construction, versus operations. The ESG risks and opportunities may therefore need to be considered differently in each stage. Furthermore, an investor needs to consider what should be required."
>
> Delilah Rothenberg, Pegasus Capital Advisors

WHO TO ENGAGE

When engaging investee companies, investors can meet with a range of key decision makers and internal stakeholders:

WHO TO ENGAGE?	WHAT TO ENGAGE THEM ON?
Board representative(s)	Should set guidance for the company on ESG management.
C-suite level, including CFO, CEO, COO	Demonstrates leadership commitment. Useful to get appropriate level of attention/resources/commitment.
Procurement decision makers	Able to answer the more technical questions on supply chain management.
General counsel	A helpful perspective on supply chain issues related to regulations/compliance/liability/risk assessment.
Sustainability/ESG professionals	Holistic view on the various stakeholders engaged on the topic (e.g. clients/customers/competitors/communities/civil society NGOs/E&S consultants).
Quality management professionals	Provide overview of systemic management processes and systems that may incorporate or be relevant to supply chain management of ESG risks. This may include the audit function.
Impacted stakeholders and their representatives	Help assess performance of the company's ESG risk management.

STAGE 1: PRE-ASSESSMENT

Pre-assessment is used by investors to identify key risk areas – for example, conflict minerals in solar panels, and human rights issues in garment industries – to help highlight any red flags and steer the focus of the due-diligence process (and resulting engagement plans for ongoing stewardship of a company).

Pre-assessment can be done remotely as part of early stage due diligence, referring to reports and data published by the investee company (annual reports, memberships, partnerships etc.), and information from third parties such as NGOs and data providers such as SASB, GRI and CDC.

STAGE 1: GENERAL SUPPLY CHAIN KNOWLEDGE AND INITIAL ESG RISK ASSESSMENT	
Size of the investee company	SME/large corporate? Note: indicative of resource availability to manage ESG risks and opportunities, and of the nature of procurement in these companies. It should not be assumed that large companies will necessarily have better operating practices and procedures, or longer supply chain relationships than smaller entities, who may have close relationships with suppliers. Nor should it be assumed that large companies have greater ESG risks than smaller companies, as ESG risks can be material to both large and small companies.
Geographical risk	▪ What percentage of your supply chain operates in high-risk countries (e.g. non-OECD countries): tier one, tier two, tier three, etc. ▪ What percentage of your supply chain spend is in non-OECD countries? Tier one, tier two, tier three, etc. Note: Geographical location provides an indicator of local legislation and enforcement. Non-OECD countries may have lower standards which could pose increased social risks such as bribery and corruption, human rights, and labour standards, as well as environmental risks such as deforestation. However, systemic risks such as climate change have the potential to affect all countries (beyond non-OECD designated countries.

STAGE 1: GENERAL SUPPLY CHAIN KNOWLEDGE AND INITIAL ESG RISK ASSESSMENT	
Sector materiality - scope and measures	▪ Which specific ESG issues do you determine as having a potentially material environmental or social impact? ▪ Which specific ESG issues do you determine as having a potentially material operational/ business impact? ▪ Which ESG issues are subject to due diligence, and which do you measure? Directly, tier one, tier two, etc. ▪ Have you benchmarked your supply chain ESG performance?
Sector materiality - assessments	▪ Have you analysed the ESG risks in your supply chain? Tier one, tier two, tier three, etc. ▪ What audit/checks do you perform on your supply chain? Tier one, tier two, tier three, etc.

Severity of risk - environmental and social	▪ Have you considered the severity of potential adverse impacts? Note: In accordance with the UN Guiding Principles on Business and Human Rights and the OECD Guidelines for MNEs, this risk analysis is undertaken by considering the scale, scope and irremediable character of an adverse impact:
	  ▪ Scale refers to the gravity of the adverse impact.
	  ▪ Scope concerns the reach of the impact, for example the number of individuals that are or will be affected or the extent of environmental damage.
	  ▪ Irremediable character means any limits on the ability to restore the individuals or environment affected to a situation equivalent to their situation before the adverse impact.

Complexity	▪ How many tiers are there in your supply chain? ▪ What proportion of goods and services are provided by direct suppliers? Note: The number of supply chain "lines" and the number of tiers that each line will reach can vary significantly within a company's procurement of goods and services. The longer the supply chain, the more likely there may be issues – e.g. the garment sector has a relatively long supply chain.
Market dynamics	▪ Is the market characterised by oligopolistic buyers with significant leverage over suppliers? ▪ Are buyers exposed to significant price competition? (if yes, there is a risk of exploitation of suppliers, either at tier one or further down, due to cost cuts being passed on). ▪ Describe the uniqueness/critical nature of the products or services you provide (to clients/customers/communities)? ▪ Which members of the supply chain (tier one, tier two, tier three etc.) are unique/ critical to you? ▪ Detail how you have diversified your suppliers and your ability to switch suppliers.

STAGE 2: DUE DILIGENCE, AND STAGE 3: ONGOING STEWARDSHIP

The aim of due diligence is to establish a performance baseline and determine if ESG supply chain risks are being acceptably managed. Due diligence questions follow topics addressed at pre-assessment. They can be revisited during ongoing stewardship and asset management as a framework for discussions on performance targets and monitoring.

> "We do not expect perfection. We're pragmatic and well aware of the challenges of making ESG work 'on the ground', especially when it comes to managing complex supply chains. However, we are also responsible investors and we do expect our GPs to put policy into practice. We expect to see evidence of ESG issues being tackled, because we know they can pose material risks for company supply chains."
>
> Adam Black, Coller Capital

ENGAGEMENT QUESTIONS

The following questions are grouped into four categories to facilitate the understanding of the investee company's management of their supply chain:

- People
- Process
- Policy
- Performance

The questions are not a prescriptive list and offer options to choose from, depending on the nature of the engagement.

PEOPLE

Explain how your company has an adequate and competent resource to identify and manage supply chain ESG risk and opportunity?

In-depth questions:

- At what level in the organisation are individuals with responsibility for supply chain ESG risk and opportunity management positioned?
- Is the responsibility and accountability for supply chain ESG risk and opportunity management clearly defined in their job role?
- How is their success measured?
- Are there policies and procedures for material ESG risks and opportunities in the supply chain to be reported to senior management and the board? If so, please describe.
- Does your sustainability lead have direct interactions with your procurement lead?
- What are the qualifications/competencies of the individuals with responsibility for supply chain ESG risk and opportunity management?
- How do you ensure that procurement and sustainability KPIs are complimentary and not conflicting?
- Describe the training and other activities undertaken to ensure board members and senior management are competent regarding ESG risks. How frequently?

PROCESS

How do you measure your direct suppliers' performance on ESG issues?

In-depth questions:

- Do you require ESG KPIs reporting from your direct suppliers? If so, can you provide examples? Do your contracts with direct suppliers allow you to audit specific ESG KPIs?
- Do you require your direct suppliers to receive ESG reporting from their suppliers? Does your contract with your direct supplier require them to provide this reporting to you or allow you to audit compliance with this requirement?

PROCESS

How have your direct suppliers (tier one supply chain) been identified and recorded with consideration to materiality of ESG risks?

This would include the location, size and sector of the supply chain companies and the ESG risks associated with them.

In-depth questions:

- How has the second-tier supply chain been mapped?
- How have subsequent supply chain tiers been mapped? All the way to the primary source? Which tier does your knowledge and influence penetrate to?
- What are the key transparency/visibility constraints in your supply chain? What efforts have you made to overcome these constraints?

PROCESS

How do you actively engage with your direct suppliers on ESG matters that are material to those suppliers' operations?

In-depth questions:

- Does your procurement process include any ESG due diligence components? If so, which ones? If so, do you do so upon onboarding? How frequently thereafter?
- How do you actively engage your supply chain to promote ethical behaviour?
- How do you identify stakeholders, their interests, as well as their legal rights, and respond to their expressed concerns?
- How do you ensure that you comply with legal requirements in all jurisdictions in which your organisation operates, even if those laws and regulations are not adequately enforced? Do you periodically review its compliance with applicable laws and regulations?
- How do you ensure that where the law or its implementation does not provide for adequate environmental or social safeguards, you strive to respect, as a minimum, international norms? Please specify any international standards that you adopt in regards to this matter.
- How do you ensure, respect and promote the rights set out in the International Bill of Human Rights?
- How do you engage in collaborative initiatives with multi-stakeholders, aimed at managing ESG risks?

PROCESS

How do your contracts with your direct suppliers take account of ESG issues that are material to those suppliers' operations?

In-depth questions:

- How are ESG issues taken into consideration when tendering new contracts with new suppliers?
- Do you have long-term partnerships (three years +) with most of your supply chain members (ideally as a formalised contract but could be regular provision of services with no ongoing contract)?
- On which terms do you primarily engage with your supply chain? (Multi-choice ranging from no-contract, short-term contact to long-term partnership)
- Do your contracts with direct suppliers allow you to audit their ESG performance?
- If minor breaches are identified, how do you work with your suppliers to rectify the issue(s)?
- Do your contracts with direct suppliers provide for a termination right or other right in your favour in the event of material ESG non-compliance (e.g. corruption, human rights violation, environmental breach)?
- How do you provide preferential contract placement with suppliers that have robust ESG risk management and performance (thus giving suppliers the confidence to invest in improvements)?

> "Adopting a policy is just the first step. That policy needs to be implemented, assessed for effectiveness and updated as necessary – it needs to become embedded in the culture of the company in order to be truly effective."
>
> Amanda Wallace, JP Morgan Asset Management

PROCESS

Do you have the contractual right to audit compliance with the ESG/sustainability policy statements relevant to supply chain?

In-depth questions:

- How do you audit your supply-chain? (ranging from: not at all, desk-based, phone interview, in-person interview, on-site audit, unannounced on-site audit)
- What percentage of direct suppliers do you audit, and how do you determine which suppliers to audit?
- Do your audits include unannounced visits by independent auditors?
- How often do you visit your tier one suppliers? And tier two?
- What actions do you take when a (major or minor) non-conformity is found during audit?
- Do you reward suppliers that improve their performance?
- Does your direct supplier audit plan include any ESG components? If so, which ones?
- Do you require your direct suppliers to report ESG incidents (e.g. health and safety incidents) to you? How frequently? What percentage of your direct suppliers have performance above their industry averages? What percentage of your direct suppliers have performance below their industry averages?

POLICY

Does your company have policy(ies) in place related to supply chain ESG risk and opportunity management?

In-depth questions:

- Which standards/guidelines/codes of practice/charter have you formally signed up to? Do you use these to evaluate your performance-relating ESG issues?
- Do you have a supplier code of conduct? Does it include ESG issues? Is it aligned with the standards/guidelines/codes of practice/charter that you have formally signed up to?
- At what level of management are your code of conduct and policy(ies) approved and authorised internally? Does this include board-level oversight?
- How are your code of conduct and policy(ies) communicated to your suppliers? In what languages are they available?
- Do you require your direct suppliers to comply with your code of conduct when providing services on your behalf? Do you require your direct suppliers to comply with your ESG policies when providing services on your behalf?
- How many/which suppliers agree to comply with your code of conduct and your ESG policies?
- Do you review your direct suppliers' policies and procedures? At onboarding? Annually? Do you have the contractual ability to audit their compliance with their policies and procedures?
- What percentage of your direct suppliers have a robust policy covering ESG issues? What percentage have robust processes supporting their policy?
- Do your direct suppliers agree that they will comply with human rights obligations, and if so, how are those obligations defined (e.g. UN Guiding Principles on Business and Human Rights)?
- Do you require your suppliers to have the same requirement(s) of their supply chain as you do of them? Is performance reported back to you?
- What confidential whistle-blower/grievance mechanisms do you have?
- Do you require any independent third party certifications? Which ones?

PERFORMANCE

Do you require your direct suppliers to report on environmental and social issues/events that could have significant impacts? (Material ESG issues and events)

In-depth questions:

- How many of your direct suppliers report, either directly to you or publicly, on their material environmental and social performance indicators – for example, environmental and social initiatives or footprint (e.g. carbon or water footprint)?
- How do you incorporate your engagement and performance of your supply chain in your own reporting?
- How have you set relevant measurable performance targets internally associated with supply chain ESG risk management?
- Have you developed a roadmap for ESG supply chain improvement?
- Has your supply chain developed their own roadmap? Tier one, tier two, etc.

PERFORMANCE

Have any of your direct suppliers had any claims made against them in the past five years regarding unfair wages, unfair hours, unfair working conditions or discrimination or other ESG issue?

In-depth questions:

- Over the last five years, how many direct suppliers have you replaced due to ESG management concerns? Over the last five years, how many direct suppliers have experienced public reports of ESG failures?
- Over the last five years, how many new supplier relationships have included ESG diligence?
- Over the last five years, how many direct suppliers have you worked with to enhance their understanding and management of ESG concerns?

EXAMPLE OF TOPIC-SPECIFIC QUESTIONS: CORRUPTION

During the process of engaging with a portfolio company on its supply chain management, it may be necessary to drill further into a topic-specific issue to gain a better understanding of the associated risks. The UN Global Compact's Fighting Corruption In The Supply Chain: A Guide For Customers And Suppliers (2016) provides resources to address corruption and assess risk, including the questions below.

- What are the possible points of contact with government corruption?
  - Is the supplier subject to government inspection?
- Does the supplier require government licensing?
  - Are the goods subject to VAT or other taxation?
  - Is the supplier responsible for dealing with customs officials?
- Is the supplier being engaged as an agent specifically to deal with the government, for example, to obtain licenses or permits or to deal with customs or tariffs?
- What is the suppliers relationship to the government?
  - Is the supplier government-owned?
  - Does the supplier have a family relationship to a government official?
- How costly would supply chain disruption be if the supplier engaged in corruption?
- What are the operational risks of such disruption?
- What are the risks to a company's reputation if such disruption occurs?
- What are the possible remedies if there is a problem with the supplier?
- How will you control the damage in each case?
- Do you have alternative sources of supply? How many alternative suppliers are there?
  - Is this a "strategic supplier"?
  - Who has the leverage in the relationship?

MORE QUESTIONS

ASSESSING THE ROBUSTNESS OF QUESTION RESPONSES

Responses to questions provided by portfolio companies will vary significantly based on the extent of existing supply chain management, as well as the resources available to contribute to the engagement.

The box below runs through the initial responses that might be received from a portfolio company following initial engagement.

EXAMPLE QUESTION AND RESPONSE

Explain how your company has an adequate and competent resource to identify and manage supply chain ESG risk and opportunity

Response:

- The procurement director is a member of CIPS. The chief sustainability officer is a member of IEMA. Both report to the CFO. They work together and incentives are aligned through the same KPIs.
- The procurement director and CSO are jointly responsible for the company's Sustainable Procurement Policy and Practice, including the company's Supplier Sustainability Code.
- KPIs aligned with the code are monitored monthly and reported to the board on a quarterly basis.

To assess the level of information that has been provided and to consider engaging on the issue further, the following can be considered:

BASIC RESPONSE

A response limited to the following:

- Listing suppliers by tier.
- Identifying material ESG issues (at least in tier one).
- Outlining the approach to managing and monitoring supplier performance.

ADEQUATE RESPONSE

A response including features from a basic response in addition to:

- Providing evidence of policies and systems being implemented.
- Describing the metrics used to measure supplier performance.

GOOD RESPONSE

A response including features from a basic and adequate response in addition to:

- Demonstrable and pragmatic action plans, focused on material ESG risks in the supply chain, irrespective of tier.
- Evidence of monitoring performance with metrics.
- Evidence of third party review.
- Case studies and examples.

In the case where a response is deemed insufficient, or more clarity on a particular issue is required, the list of engagement questions above can be used to obtain more in-depth information.

CONCLUSIONS AND NEXT STEPS

CONCLUSIONS

Risks presented by ESG factors in supply chains are constantly emerging. Left unmanaged, they can harm the reputations, operations and financial performance of businesses and assets owned by investors. This can ultimately reflect on investor reputation and investment performance.

Investors should engage with investee companies to ensure that both a framework is in place that effectively identifies and assesses ESG risks in the supply chain with their direct suppliers; and to ensure this framework is implemented throughout supply chain tiers. Effective engagement will include a variety of internal stakeholders from various levels and departments of the investee company, as well as a range of external organisations. The management of ESG supply chain risks is an ongoing process and requires continual improvement from investors and investee companies to achieve a developed approach to better understand and manage exposure in a rapidly-changing world.

NEXT STEPS

While the PRI has attempted to futureproof this framework to the extent possible, inevitably it will need to be adapted with the support of investors engaging on this issue as new demands and trends emerge.

The PRI is seeking feedback to develop this guide and would be very grateful for your support. Following the launch of the paper, the PRI will invite a number of signatories to pilot the toolkit and give practical examples demonstrating how it fits into their overall investment process.

We ask readers of the guide to:

- use it as a pilot or part of your formal procedures and apply it to existing investment entities;
- provide the PRI with feedback on its effectiveness; and
- share relevant case studies highlighted in your application of it.

Beyond this, if there is sufficient demand from investors, the PRI will also consider the development of a second tool to help investors consider the materiality of specific ESG issues across different sectors within their supply chain.

Please send all feedback, case studies and other information to supply.chain@unpri.org.

CREDITS

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GLOSSARY

Due diligence	Robust checks undertaken as part of the initial investment review stage, in order to determine the attractiveness of an investment opportunity prior to investing.
Direct suppliers	Tier one supply chain companies, providing goods or services.
Indirect suppliers	Tier two, three and further, where they provide goods/services to an intermediary, who in turn provide goods/services to the investee company.
ESG	Environmental, social and governance. A term used by the investment community to encompass a range of factors that are incorporated into responsible investment decision making. ESG criteria are a set of standards for a company's operations that investors may use to screen investments. ▪ Environmental criteria look at how a company performs as a steward of the natural environment. ▪ Social criteria examine how a company manages relationships with its employees, suppliers, customers and the communities and wider stakeholders where it operates. ▪ Governance deals with a company's leadership, executive pay alignment, audits and internal controls, and shareholder rights. Investors who want to purchase securities that have been screened for ESG criteria can do so directly and through socially responsible funds.
ESG risk	This can take many different forms encompassing operational risks as well as human rights risk (risk to people, not risk to the company) or negative E&S impacts which then become reputational risks or financial risks.
LP	Limited partners. LPs serve as the primary source of capital into funds, which are often managed by general partners (GPs). Examples of LPs include pension funds, insurance companies, endowments, family offices, high net worth individuals, etc.
GP	General partners. GPs manage funds and execute investments with LPs' or shareholders' capital, with the aim to return that capital to the LPs or shareholders.
Material/ Materiality	Classification of the issues deemed to have a significant impact on a business, (which can include ESG issues). There are a variety of approaches to determining whether an issue is material to a business (e.g. the Sustainability Accounting Standards Board, Global Reporting Initiative, among other approaches).
Natural capital	The world's stocks of natural assets which include geology, soil, air, water and all living things. It is from this natural capital that humans derive a wide range of services, which make human life possible.
OECD	Organisation for Economic Co-operation and Development. The OECD promote policies that will improve the economic and social well-being of people around the world. OECD member countries tend to have more robust regulations associated with ESG issues.
Onboarding	The process of a company engaging and selecting suppliers in its supply chain.
Ongoing stewardship	The process of supervising and taking care of the investee company over the period of asset ownership.
Pre-assessment	The initial evaluation of the investee company and their approach to ESG supply chain risk management. This is the first step in the evaluation process, and investors may be able to undertake much of this evaluation remotely.
Social capital	Refers to the connections between individuals and entities that can be economically valuable. Social networks that include people who trust and assist each other can be a powerful asset.
SDGs	United Nations Sustainable Development Goals. The SDGs are the goals of the 2030 Sustainable Development Agenda, which is a plan of action for people, planet and prosperity. The SDGs run from 2015 to 2030. There are 17 goals and 169 specific targets for those goals.
Supply chain	Companies providing products and services to the investee company. It is recognised that often the supply chain can be a complex, inter-related 'web' rather than a linear 'chain'.
Tier	The layers of a supply-chain. Tier one companies provide goods/services directly to the investee company. Tier two companies supply companies in tier one; tier three supplies tier two, etc. All these tiers form part of the supply-chain of the investee company.

APPENDIX I: SUPPLY CHAIN RESOURCE MAP

INTRODUCTION

To support this guide, the PRI is developing a resource map containing over 150 sources of guidance and tools directly or indirectly related to ESG and supply chains. The criteria used to prioritise these items include:

- relevance to E, S or G issues;
- relevance to supply chains; and
- relevance to specific sectors within a supply chain.

The aim of the resource map is to give investors a reference guide to relevant resources as part of their ESG supply chain due diligence process.

STRUCTURE

The selected resources will be split into two groups.

LIBRARY 1

Existing ESG guidance and tools of high relevance to supply chains – a priority of existing initiatives: outlining content, scope, synergies and how they work.

LIBRARY 2

Signposting other existing guidance and relevant guidance and tools on specific ESG issues of relevance to supply chain.

RESOURCES MAP CRITERIA

The criteria used to categorise resources in the map are based on those in the International Standard ISO26000 Corporate Social Responsibility. (The new International Standard on Sustainable Procurement (ISO20400) also uses ISO26000 as its basis).

Key criteria include:

- Format
- Sector
- Geographical focus
- ESG issue:
  - Organisational governance
  - Human rights
  - Labour practices
  - The environment
  - Fair operating practices
  - Consumer issues
  - Community involvement and engagement

The associated risk and relative importance of each of the above issues will vary based on the particular corporate's supply chain characteristics.

For more information please contact supply.chain@unpri.org.

APPENDIX II: CASE STUDIES

ADDRESSING CONFLICT MINERALS IN SOLAR POWER PRODUCTION

INVESTOR NAME	**JP Morgan Asset Management**
HQ LOCATION	**New York**
OPERATIONS	**Investment Manager**
US$ AUM	**Over $120bn in Global Alternatives**
ASSET MIX	**Multi-asset**

Sonnedix is a group of companies that develops, builds, owns and operates solar power plants globally. It is owned by institutional investors advised by J.P. Morgan Asset Management (JPMAM) within an infrastructure strategy. As part of its overall efforts to better understand, mitigate and manage ESG-associated risks and opportunities, JPMAM actively encouraged Sonnedix to make ESG issues a priority by requesting that they formalise their practices through the implementation of ESG management systems aligned to accepted international standards.

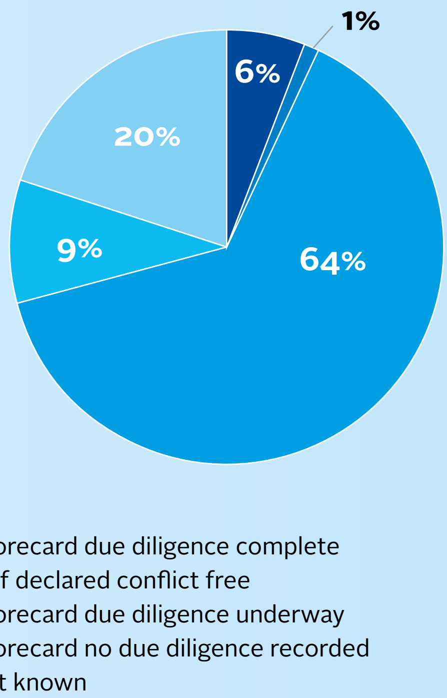
As a solar power producer, PV modules are arguably the most critical component of Sonnedix's business. Sonnedix was asked by JPMAM to evaluate how, and to what degree, conflict minerals (specifically, tantalum, tin, gold, and tungsten) are present in Sonnedix's supply chain and how this should be considered and addressed in its business. Responsible mineral sourcing can help avoid both human rights abuses as well as the contribution to conflict fuelled by the extraction and trade of minerals.

As a first step, Sonnedix analysed conflict mineral use through publicly available independent third-party PV module manufacturer scorecards. These scorecards determine the degree to which module manufacturers have done due diligence and can confirm with reasonable certainty that they do not use conflict minerals per the due diligence guidance outlined by the OECD, and produce supporting documentation.

Recognising the limitations facing a small company with an ESG team of two, Sonnedix used these third-party scorecards, rather than independent supplier-by-supplier audits, as it allowed them to incorporate conflict minerals management into their larger ESG programme without unnecessarily draining the team's time or budget.

Sonnedix is currently finalising how best to incorporate scorecard results into their business decisions. Both Sonnedix and JPMAM are aware that any such decision will need to balance the value of these score card results against other business concerns (such as costs, performance and availability of the modules), as well as, take into account potential impacts on Sonnedix's procurement processes, acquisition criteria, and other business lines.

PV panel status - confict minerals - all projects
Total panel count: 1,911,526



JPMAM's push to consider the impact of conflict minerals, together with Sonnedix's realistic approach to analysis and resource management, resulted in a more developed ESG approach to addressing the potential risks, with a broader scope than would be expected for an organisation of its size. This process has driven thoughtful discussion between Sonnedix and JPMAM regarding integrating ESG into the business's larger strategy.

WORKING WITH AN EPC CONTRACTOR ON HIGH-SPEED RAIL

INVESTOR NAME	**Meridiam**
HQ LOCATION	**Paris**
OPERATIONS	**Investment Manager**
US$ AUM	**7.14bn**
ASSET MIX	**Infrastructure**

Meridiam is one of the majority stakeholders in Lisea, a French rail infrastructure company that delivered the €7.8 billion Sud Europe Atlantique (SEA) project, a new high-speed railway line between Tours and Bordeaux,. Meridiam works closely with the other stakeholders to set financial and managerial goals, including ESG performance objectives. Initiated by the state-owned body responsible for railway infrastructure, SNCF Réseau, this public-private partnership (PPP) project covered funding, design and construction, and maintenance over a 50-year period.

In a PPP like this one, Lisea takes up the role public authorities have in a classic public procurement scheme and will therefore manage procurement and suppliers. During the project construction phase, the main supplier is the engineering-procurement-construction (EPC) contractor. In this case , the EPC contractor is one Meridiam has built a trusting relationship with through previous projects, which was a contributing factor in Meridiam's decision to invest in the SEA project. It also proved to be valuable for Lisea when discussing and establishing ESG KPIs, allowing Lisea to request clarifications and corrections when needed.

In this scheme, Lisea has to meet the public authorities' requirements but depends mostly on its first supplier, the EPC contractor, to deliver a project that complies not only with local laws and regulations, but with a vast array of ESG commitments and objectives set by Meridiam and other Lisea stakeholders. For instance, the project footprint impacts 11 Natura 2000 sites[1], where more than 200 protected species can be found. Although mitigation and compensation measures for environmental impacts are contractual requirements, non-compliance of the supplier would have caused reputational damages to Lisea. In such an ecologically sensitive area, teaming up with a supplier with strong ESG credentials reassured Lisea that mitigation measures would be implemented as planned and that stringent monitoring would be ensured.

Lisea monitored the supplier's performance against an array of ESG targets which were defined by Meridiam and the other stakeholders, as well as those set in the project management plans. They covered, among other issues, training for workers, health and safety, compliance to environmental permits and community engagement. To reinforce the collaborative relationship with the EPC contractor, feedback was given for its performance on an on-going basis and best ESG practices, amongst others, were promoted widely. This was achieved through various methods including social media and public presentations and exhibitions.

1 A Natura 2000 site is designated by the European Commission as part of a network of core breeding and resting sites for rare and threatened species, and some rare natural habitat types which are protected in their own right (http://ec.europa.eu/environment/nature/natura2000/index_en.htm).

ESTABLISHING AN ETHICAL SOURCING "HEALTH CHECK"

INVESTOR NAME	**Partners Group AG**
HQ LOCATION	**Zug**
OPERATIONS	**Investment Manager**
US$ AUM	**66bn**
ASSET MIX	**Multi-asset**

Partners Group is an investor in Action Nederland BV ("Action") on behalf of its clients. Action is a Netherlands-based discount retailer offering a range of stationary, household goods, cosmetics, food stuffs, toys, textiles, glass, chinaware and pottery, decoration accessories and do-it-yourself products. The company aims to offer around 150 new articles in its stores on a weekly basis, sourcing from dozens of countries.

In early 2014, Partners Group and Action management recognised the growing investment and reputational risk from not staying ahead of rising ethical standards in Action's supply chain. Key risk factors included potential damage to brand and reputation, staff morale, and exposure to legal risks. Action subsequently commissioned an ethical sourcing "health check," to benchmark Action's performance relative to peers and industry best practice, pinpoint the areas of greatest risk, and prioritise intervention areas in its responsible sourcing strategy. The process included interviews with the company's CEO, procurement managers and communications department, which provided insights on how the company established its procurement strategy, how it monitored its suppliers and how it communicated to them and its customers. The "health check" raised the need for Action to establish a stronger ethical sourcing culture: the policies, vision and strategy from senior management that could signal the importance of the topic.

Following the health check, Action established an ethical sourcing policy and supplier code of conduct that outlined expectations to suppliers which were clearer than the brief, high-level language previously included in the standard terms and conditions. For example, the new guidance articulated expectations around preventing child labour and paying fair wages and made membership to the Business Social Compliance Initiative (BSCI) compulsory.

Action followed this step by asking its domestic suppliers to complete an ethical sourcing self-assessment through an online portal, designed to generate a low, medium, or high-risk rating, subject to data validation from an independent third party. Action then sent each supplier a tailored set of recommendations based on each individual risk rating, with deeper engagement planned for higher-risk suppliers.

With this foundation in place, Action has now set its sights on the next phase of its ethical sourcing initiative. Priority next steps include developing a formal escalation process and a set interval for how often to reassess suppliers to monitor progress. It will also look to take full control of the ethical, safety and social conditions of the factories its domestic import partners use to manufacture and supply its Private Labels from.

IMPROVING SUB-CONTRACTOR WORKING CONDITIONS FOR A RENEWABLE ENERGY PLATFORM

INVESTOR NAME	**Actis**
HQ LOCATION	**London**
OPERATIONS	**Investment Manager**
US$ AUM	**7.6bn**
ASSET MIX	**PE/Infra/Real Estate**

In 2014, Actis committed US$280m to establish a wholly-owned Indian renewable energy platform, Ostro Energy (Ostro). Actis's responsible investment (RI) team worked with Ostro's management to recruit and install a head of ESG to oversee environmental, social and governance (ESG) issues and manage and mitigate any related risks. Ostro's head of ESG reports to the CEO.

One of the ESG challenges which was identified very early on was labour standards in the supply chain – specifically the working conditions onsite for all workers, including sub-contractors. A monitoring site visit by the Actis RI team together with the Ostro head of ESG identified gaps in working conditions and paved the way for the development of an improvement programme. Working collaboratively, Actis's RI team and Ostro developed standards for worker accommodation and labour conditions, as well as guidance regarding access to safe drinking water and sanitary facilities. The outcome was the Ostro Labour Accommodation Standards Policy, based on international best practice (drawing from IFC/EBRD guidance). Therefore, soon after Actis set up Ostro as a renewable energy platform, the company has ensured that the policy forms part of the legal agreement with contractors, and is therefore applied systematically across all projects.

Improvement of working conditions delivers multiple benefits: workers raise fewer grievances and are more productive, and Actis's experience has shown that overall turnover is lower at projects which provide favourable working conditions. By setting a policy which aligns to international standards and is implemented by the contractors in its supply chain, Ostro de-risked its assets and simultaneously built capacity amongst its contractors. This approach has helped Ostro to secure project finance by meeting lenders' rigorous ESG standards.

ANALYSING MATERIAL RISKS IN A SUPPLY CHAIN IN CHINA

INVESTOR NAME	**HESTA**
HQ LOCATION	**Melbourne**
OPERATIONS	**Superannuation fund for the health and community services sector**
US$ AUM	**30bn**
ASSET MIX	**Multi-asset**

ANALYSING ESG RISKS IN A FASHION BUSINESS'S SUPPLY CHAIN

HESTA co-invested with a GP in a retail business that sells women's accessories. The GP, as part of the investment analysis, undertook an ESG due diligence on the company's supply chain in China. The GP's analysis highlighted the long-term, direct relationship between the company and its Chinese suppliers, along with regular visits by the company to the suppliers' factories and the requirement for the suppliers to fill out a 'capability statement' to ensure operations met minimum capabilities and standards.

When reviewing investment opportunities, HESTA uses a proprietary ESG due diligence/monitoring framework[1] to identify the most material issues, depending on the company's industry. Material risks are analysed and contrasted with mitigants identified in the GP's due diligence. In this case, most of the supply chain risk mitigants relied on anecdotal information, such as factory visits. HESTA built on the GP's due diligence and followed up with questions to better understand the accountability measures the company had in place.

While HESTA was sufficiently comfortable with the answers provided by the GP and the company to proceed to investment, they will continue monitoring post-acquisition management of supply chain risks. HESTA has an observer seat in the board of this co-investment, which allows them to gain more nuanced insights of the company's approach to ESG issues.

HESTA'S ROLE AS AN LP:

When investing with a GP, HESTA's role in assessing ESG risks and opportunities is to oversee, and ensure they are comfortable with, the GP's ESG assessment of the deal. Key elements it looks for are:

- ensuring due diligence covers a broad and relevant range of ESG risks and opportunities when assessing materiality and avoiding narrow approaches (i.e. limited to OH&S issues);
- ensuring that the most material risks have been addressed, and where relevant, included in valuation, decision making and the post-acquisition asset management;
- verifying that risk mitigants are established, ideally as robust documented policies and processes in portfolio companies, including compliance reporting.

When an ESG risk is not material enough to prevent investment, but could impact the company in the future, HESTA reviews the GP's plan for monitoring and addressing the risk post-acquisition.

1 T he ESG due diligence and monitoring framework is based on the Sustainability Accounting Standards (SASB) materiality map: http://materiality.sasb.org/

ACTIVE ENGAGEMENT ON MANAGING SUSTAINABILITY IN THE HOSPITALITY SECTOR

INVESTOR NAME	**Pegasus Capital Advisors, L.P.**
HQ LOCATION	**New York**
OPERATIONS	**Investment Manager**
US$ AUM	**1.9bn (as of 31/12/16)**
ASSET MIX	**PE/Infra**

SIX SENSES SUPPLY CHAIN MANAGEMENT

Six Senses Hotels Resorts Spas is a luxury hotel and spa operator headquartered in Bangkok, Thailand, with 12 resorts and 20 spas globally.

When Pegasus added Six Senses to its private equity portfolio, it required that the group engage an executive-level head of sustainability. A vice president of sustainability was hired and tasked with development and implementation of a sustainability management system to guide core business activities, including the supply chain.

Six Senses' supply chain relationships range from large-scale international to small-and-independent local businesses. As such, Six Senses recognises the importance of managing risks and opportunities of these varied supply chains to maximise brand value and to protect local communities and environments. While there are sustainable sourcing requirements for specific items (e.g. fish and seafood, prioritisation of local and organic food, and sustainable certification for wood and fabrics), each property has a unique supply chain and therefore differing material issues. Therefore, Six Senses also requires each property has its own sustainable procurement program, which includes an initial and annual review of procurement items and suppliers, improvement targets (with responsibilities and timelines), engaging suppliers on improvements needed, and reporting.

Subsequent improvements include the termination of a non-certified palm oil supplier contract replaced with an alternative meeting Six Senses requirements; as well as the development of a sustainable fishing education programme for local fishermen supplying a Maldives resort property. As an incentive, the property committed to procure whatever was caught from that day's catch as long as it wasn't on the "do not serve" list, resulting in a win-win situation for the fishermen and resort.

MONITORING AND REPORTING

Reporting consists of an annual on-site audit (lasting about half a week) by either the Director of Sustainability or VP of Sustainability. Outcomes are built into both a Sustainability Action Plan (with required action, responsibility and timeline) and a report. Both are shared with the property General Manager, the group CEO, the group President and the group Executive Committee. Identified risks are flagged for executive review and support. Six Senses has a monthly corporate Sustainability Strategy meeting in which executives meet to discuss high-priority items. As the majority shareholder in Six Senses, Pegasus stays in regular contact with Six Senses management on material issues, including supply chain matters, as deemed appropriate. Six Senses also submits an annual Sustainability Report to Pegasus.

CONTINUED IMPROVEMENT

In 2017, Pegasus intends to reach out to each of its portfolio companies, including Six Senses, to develop a Supplier Code of Conduct with basic requirements for supplier commitments to ESG best practices. Environmental, health, safety, human rights, and certain governance issues are expected to be included in the code of conduct. Portfolio companies, including Six Senses, are expected to monitor suppliers' compliance with the code of conduct and work with suppliers to enhance ESG best practices, as practical and feasible. More comprehensive requirements for reporting to Pegasus on material ESG supply chain risks, opportunities, and performance are also being developed across the portfolio.

GENERATING COST SAVINGS THROUGH SUPPLY CHAIN ENGAGEMENT

INVESTOR NAME	**IFM Investors**
HQ LOCATION	**Melbourne**
OPERATIONS	**Superannuation fund for the health and community services sector**
US$ AUM	**76bn**
ASSET MIX	**Multi-asset**

Anglian Water is geographically the largest water and wastewater company in England and Wales - serving about six million customers in the east of England - and has about 4,200 employees.

The supply of water and wastewater services involves significant costs both in the installation of the infrastructure and over the life of its operation. Previously, Anglian Water's procurement was focused on a narrow definition of outputs and costs, and did not give due consideration to the outcome of better safety and environmental standards. The incentive payment structure for the suppliers was to deliver to a set timeframe and budget, but the long-term evolution of the costs, safety and environmental risk profile was not considered.

With the support of its new shareholders, IFM Investors, CPPIB, Colonial First State and 3iGroup, the team at Anglian Water initiated a collaborative, long-term approach to its procurement of key infrastructure projects across its network. This involved a redesign of the way its supply chain operates, including: developing a collaborative delivery mechanism which links the performance and incentives of each supplier to the performance of all suppliers as a group; improved performance metrics; and a focus on lowering Anglian Water's carbon footprint. The new performance metrics for suppliers focus on customer outcomes, and measurement over extended time periods that match regulatory cycles.

Investors' influence on setting targets and KPIs has played a part in instilling the cultural change required for improving procurement practices. A focus on reducing greenhouse gas emissions has spurred suppliers to develop innovative solutions, resulting in products that have both a lower carbon footprint, but also a significant reduction in costs. The new procurement model has achieved:

- annual savings of 2-3% in capital expenditure (around US$45 million), while increasing quality of service delivery to its customers over the last 10 years;
- reduced embodied carbon by 54% from 2010-2015, against a 50% target;
- reduced operational carbon by 41%, against a 20% target; and
- reduced the accident frequency rate from approximately one in every 300,000 hours worked to one in every million hours worked.

The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact