COMGEST ESG TEAM

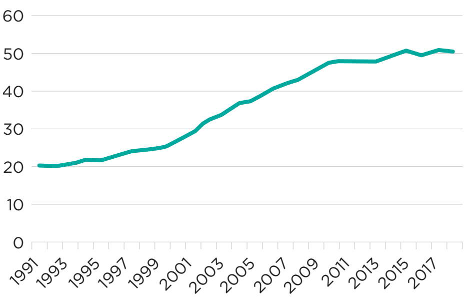
FAST FASHION AND ESG
THE TEXTILE INDUSTRY UNRAVELLED

ESGInsight
Environment & Social

- *The textile industry is changing. Fast fashion, which has boomed since the 1990s, is facing increasing scrutiny as investors and consumers weigh up the environmental cost of "disposable" garments and demand greater transparency and better working conditions within the supply chain.*
- *As an industry, there remains ample room for improvement, but some players are positioning themselves for long-term success. They are adopting more sustainable business practices and successfully marketing this stakeholder-sensitive approach to the ever-demanding consumer.*
- *Comgest uses its ESG integration approach to identify those industry leaders that are squaring up to the environmental and social risks facing the textile industry, and believed to be well-placed not just to deliver sustainable, long-term earnings growth for their shareholders but to raise standards across the industry.*

WHAT'S CHANGING IN FAST FASHION?

Figure 1: Number of items of clothing and footwear sold per person in the UK



Source: Morgan Stanley 2018

The number of items of clothing sold per person has risen rapidly since the 1990s, when the fast fashion industry took off *(Figure 1)*. There are signs of a slowdown or even a reversal in some markets, such as Sweden[1], but the volume of clothing produced is nonetheless set to increase from 62 million tons in 2015 to 102 million tons in 2030[2].

Driven by changing investor demands and consumer behaviour, a growing share of these clothes will be produced in a sustainable way, and sold through non-traditional channels. Industry leaders are responding to these trends, and, in a fragmented market, we believe are likely to gain market share by doing so.

LEADERSHIP IN THE SUPPLY CHAIN

The textile industry supply chain is characterised by poor working conditions and low wages. Many workers are not paid a local minimum wage, and even for those who are, this can be equivalent to around only 50% of a living

[1] Source: Morgan Stanley 2018
[2] Source: BCG report 2017

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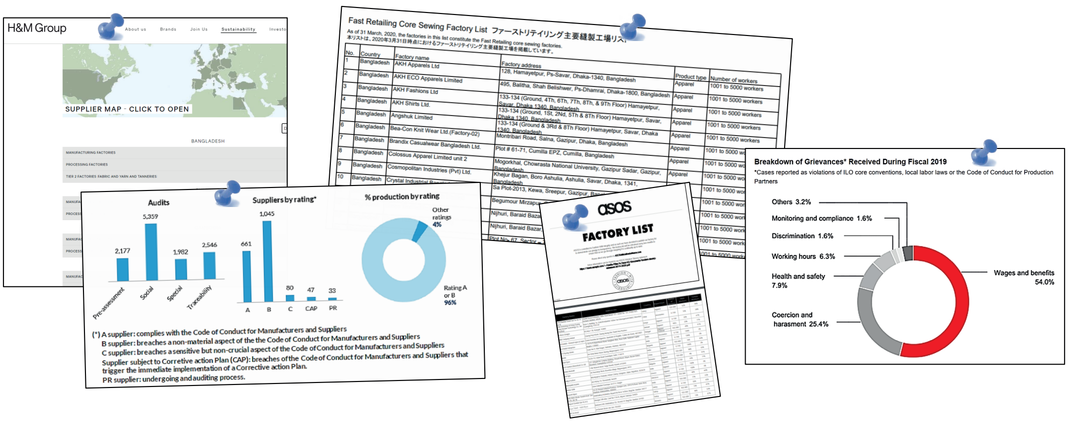
wage[3]. Injury rates are 5.6 injuries per 100 workers each year; as a comparison, this is more than double the rate in the supply chain of a major sporting goods manufacturer.

— **Since 2013, industry leaders have transformed their relationships with suppliers and started to provide disclosure.**

But this is not the full picture. Since the shocking collapse of the Rana Plaza factory in Dhaka in 2013, industry leaders have transformed their relationships with suppliers, and have started to provide investors with the information they need to verify their supply chain. H&M was the first to offer full transparency of its supplier list in 2013, and other leading retailers such as Primark and Inditex followed its example. It is not just European companies that are providing this disclosure: Japan's Uniqlo publishes full details on its website of the 248 factories and 72 cotton mills that it works with across China and South East Asia. These retailers are also changing the way they work with suppliers, encouraging them to improve conditions for employees.

Figure 2: We have come a long way



Source: Company websites (H&M group, Inditex, Asos, Fast Retailing)

— **The materialisation of ESG risks can prove to be financially very painful.**

There are still significant shortcomings within the fast fashion supply chain, as exemplified by the revelations of sweatshop conditions among the Leicester, UK factories supplying online retailer Boohoo. These governance failings ultimately resulted in a 40% drop in Boohoo's share price – a stark reminder of how ESG risks that materialise can be financially very painful indeed. Whilst the case of Boohoo continues to unfold, the immense pressure exerted by investors, customers and the general public has already resulted in the company now promising to follow the example set by the industry leaders in committing to the highest standards of

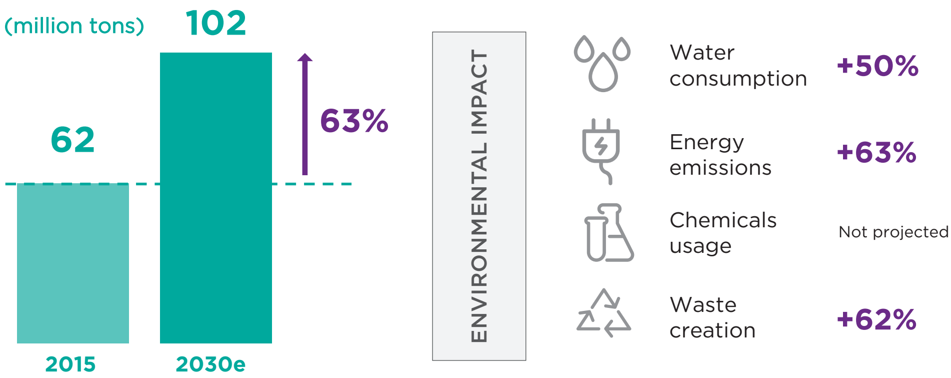
[3] Source: Global Fashion Agenda (GFA), Sustainable Appareil Coalition (SAC) , Boston Consulting Group (BCG) as of end of 2017

governance and transparency. Recently, two senior executives have joined Boohoo from Primark, bringing with them experience and expertise from that company's turnaround in the aftermath of the Rana Plaza tragedy.

SLASHING ENVIRONMENTAL COSTS

Another important element of leadership in the industry is reducing its environmental impact. The forecast growth in output to 102 million tons of clothing to be produced worldwide in 2030 implies a big increase in resource use:

Figure 3: Projected global fashion consumption



Source: BCG as of end of 2017

Figure 4: The big players are setting the standards

Source: H&M company website

Most of the bigger players in the industry have published ambitious environmental targets, developing sustainable materials and more efficient processes to cut their consumption of water, electricity, chemicals and pesticides. Inditex took the lead in this, committing in 2019 to using 100% recycled cotton and polyester and 100% sustainable linen before 2025, and its sheer size will help make these materials accessible across the industry. Inditex is the first fast fashion company to tie its CEO's objectives directly to sustainability. H&M has pledged to being climate positive by 2035, and has taken concrete steps to develop innovative materials, using natural waste products such as orange pulp and pineapple leaves *(see Figure 4)*. Similarly, Uniqlo is investing in new technologies in denim production that will cut water usage by 99% and CO2 emissions by 85%.

The industry still has a long way to go – it is estimated that the overproduction rate in brand operations is 20%, and that for every ton of garments produced, so is 1.5 tons of waste. However, roughly

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Figure 5: Re.Uniqlo Initiative

Source: uniqlo.com

half of textile companies are already using mostly sustainable materials[4] and many start-ups are working on disruptive technologies. Comgest continues to monitor this evolution closely.

RESPONDING TO CHANGING CONSUMER PRIORITIES

There has been a clear shift in consumer preferences in favour of re-use and recycling. In response, Uniqlo has launched its "Re.Uniqlo" initiative which promotes product-to-product recycling, product-to-fuel recycling, and product re-use.

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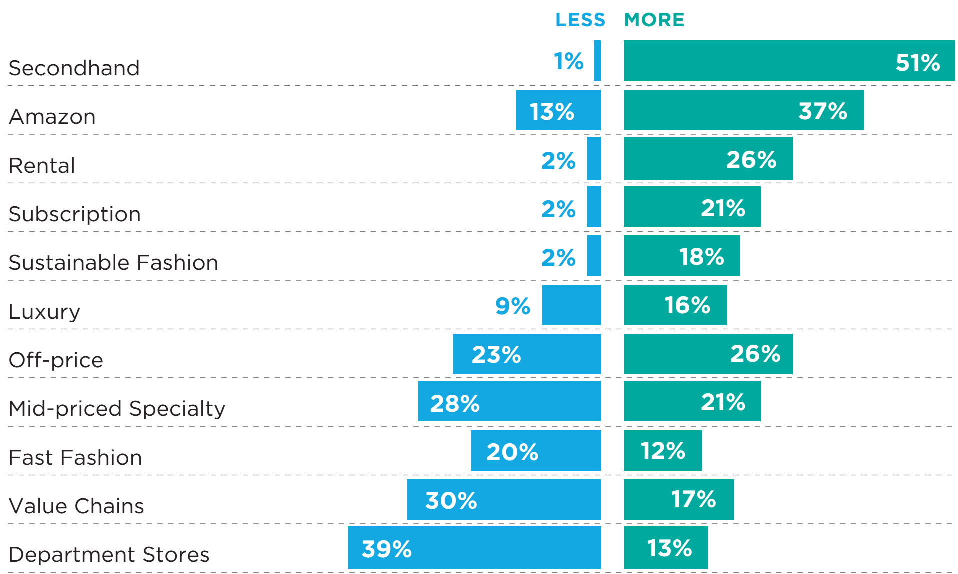
This trend is also apparent in the growth of new retail models. The market share of these new models is small, but it has doubled from 3% to 6% since 2010 and is set to double again over the next decade as consumers buy more of their clothes from non-traditional outlets *(see Figure 6)*. Just as H&M has invested through its private equity arm in technology start-ups that are developing new recycling methods, it has also invested in Sellpy, a second-hand online store. In Japan, Zozo has an equivalent model, "Zozo Used".

Figure 6: Where will you spend more or less in the next 5 years?



Source: thredUP, 2019

A clear challenge for the industry is that although consumers want textile companies to invest in innovative production and sales technologies, they are not prepared to pay a premium for the

[4] Source: GFA, BCG, Barclays Research 2019

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— Established fast fashion retailers cannot afford to ignore new consumer preferences and new competitors.

garments that are made and sold this way. While this will mean increased costs for industry leaders in the short term, we expect this to be manageable. As sustainable production is adopted more widely, this should result in economies of scale, and companies such as Japan's Fast Retailing are making other efficiency gains such as increasing automation in their logistics operations. We therefore believe that textile industry leaders can maintain double-digit operating margins over the long term. Established fast fashion retailers simply cannot afford to ignore consumer preferences, or the threat from new competitors, such as Vinted (a marketplace for used clothing), Rent-the-Runway and Air Closet subscription rental services).

ESG INTEGRATION AND INVESTING IN THE TEXTILE INDUSTRY

As with other material non-financial findings in our research, Comgest hardwires its assessment of how well different textile companies are progressing in managing environmental and social risks through its ESG integration approach. Leveraging the skills of a dedicated ESG team of analysts, the investment team gives each company an ESG Quality Level rating from 1 (leader) to 4 (improvement expected) – *see figure 7*. This rating directly impacts the discount rate applied in Comgest's proprietary models for company valuation, as follows:

Figure 7: Comgest ESG Quality Levels

Comgest Quality Level	Description	Discount Rate Impact: Developed Markets	Discount Rate Impact: Emerging Markets
1. ESG Leader	Sustainability/CSR fully embedded in corporate culture, strategy to benefit from ESG opportunities, excellent disclosure, mitigation of existing ESG risks	-50 bps	-100 bps
2. Good Quality	Good awareness and mitigation of low ESG risks, adequate disclosure, few controversies, able to benefit from ESG opportunities	0 (no change)	0 (no change)
3. Basic Quality	Basic awareness of ESG risks, limited mitigation measures in place, moderate ESG risk exposure, low disclosure, ESG controversies, room for improvement	+100 bps	+150 bps
4. Improvement Expected	High ESG risk exposure, no consideration of ESG risks, very low or absence of disclosure, no mitigation measures, significant ESG controversies, priority for engagement	+200 bps	+300bps

Source: Comgest, for information purposes only. Please note that our ESG integration process is currently applied in Comgest's main strategies – Global Equities, Global Emerging Markets Equities, European Equities, Asia ex Japan and Asia Pacific ex Japan Equities which represent more than 90% of Comgest's assets under management as of 30-Jun-2020 and is conducted most notably in Comgest's flagship funds in these strategies.

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Textile industry leaders tend to have relatively high ESG Quality Level ratings. Uniqlo is rated a “2”, reflecting a series of improvements in the management of its human and environmental capital in recent years, in large part thanks to the personal involvement of its founder and CEO. However, in the spirit of our ESG integration approach, Comgest may be prepared to invest in companies with a lower ESG ratings where there is a clearly identified opportunity for improvement and a demonstrated willingness by the company to implement the right measures. In such cases, the heightened ESG risk of the company is reflected in a higher discount rate being applied to the valuation, which impacts the investment team’s projected “upside” on the name. This in turn means that the position size is likely to be smaller until the anticipated improvements become tangible.

ENGAGEMENT AND PROMOTION – CAN FAST FASHION BECOME A FORCE FOR GOOD?

Although investors and consumers may justifiably question whether fast fashion has a place in a resource-constrained world, the actions of the leading textile companies to improve their environmental and social impact demonstrate that it is possible to act in a sustainable manner within an unsustainable industry. The detailed work underlying the ESG Quality Level rating provides an opportunity for Comgest to identify specific areas of engagement with companies in order to encourage them to make such changes.

— **Comgest works with companies and other investors to promote broader progress and we believe the industry could contribute to many of the SDGs.**

Comgest also works with companies and with other investors to promote broader progress, for example supporting the Sustainable Apparel Coalition that shares good practice and technical standards across the industry. We actively engage and promote because we can see a route for fast fashion to generate positive impacts. The industry could contribute to many of the SDGs *(see Figure 8)*, for example:

– No poverty: it is estimated that more than one-third of employees in the textile supply chain will be paid less than the minimum wage by 2030. Raising pay scales would help more than 60 million people in Asia;

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- Good health and wellbeing: by cutting the use of hazardous chemicals, working conditions could be improved in wet processing, especially in India, Bangladesh and parts of China;
- Gender equality: the brunt of low pay in the industry falls on female workers – raising pay to the local minimum would have a significant and rapid impact on gender equality.

Figure 8: Sustainable Fashion helps address several of the UN SDGs

Source: Comgest, United Nations

CONCLUSION: STRENGTHENING THE THREADS

The textile industry is changing. Leading companies are adapting their business models in response to the changing expectations of investors and consumers, and in doing so are positioning themselves to generate long-term value for shareholders. These companies are increasingly going further than simply managing their own risks, and supporting better management of human and environmental capital across the industry. Comgest's approach of ESG integration, engagement and promotion is designed to capture these developments within our research and decision-making, while we work collaboratively with other investors to encourage ongoing and much-needed progress across the industry.

IMPORTANT INFORMATION

Investing involves risk including possible loss of principal. Past performance is not a reliable guide to future performance.

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