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The Modern Slavery in Supply Chains – Investment Implications

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The Modern Slavery Act has recently passed the House of Representatives. In practice, it will introduce reporting requirements for businesses on the risk of slavery in their operations and supply chains. What does this mean for investors and how can investors contribute to positive change on labour rights and other human rights? This paper provides some ideas based on discussions with global leaders. The paper also puts a spotlight on the garment sector in Cambodia, which Ausbil recently visited.

The 'S' in ESG is becoming increasingly important

In the past, the 'S' in ESG has sometimes been referred to as the 'soft' part of ESG. However, in our view, that is not the case and in the last two years we have seen examples of what can happen in cases of improper conduct or when companies have underpaid workers. While the 'S' is not always that easy to quantify, research shows that increasingly, the proportion of company value that comes from so-called intangible drivers has increased and from our perspective, a significant part of these intangible value drivers can be classified as 'S', such as culture, staff engagement, safety performance and supplier relationships.

The importance of issues such as labour rights and other human rights, including modern slavery, is closely linked with Ausbil's investment philosophy. Ausbil believes earnings revisions drive share prices and we prefer companies with sustainable earnings and quality management. At the heart of it, if a business model relies on underpaid workers, or even slavery, or weak regulation on social issues, current earnings will unlikely be sustainable. Also, brand damage can lead to loss of sales. However, it is not all about earnings. We see ESG as a proxy for management quality. When a company does not know its own supply chain or does not understand the risks of slavery, it begs the question: what else should we worry about? Also, damaged brands can be costly and time-consuming to restore and can also have internal impacts, such as staff engagement and distraction for management and the board.

In addition, we foresee increased regulatory risk. In addition to companies being exposed for underpaying workers in Australia, leading to a government inquiry into the franchise industry, there is also increased global regulatory focus on forced labour. The UN Sustainable Development Goals aim to eradicate slavery by 2030; with only 12 years remaining we expect there will be increased regulatory activity globally. Offshore, there have also been cases brought by consumers and non-government organisations (NGOs). In 2018, 36 countries were taking steps to address forced labour in business or public supply chains versus only four in 2016 . We've already seen the UK Modern Slavery Act (MSA), various initiatives in Europe and more recently, the Modern Slavery Act introduced into Parliament in Australia where it passed the lower house in September 2018.

What is modern slavery and what is the Modern Slavery Act?

Modern slavery includes children working in slavery, forced labour, debt bondage, human trafficking, forced marriages and forced sexual exploitation. As discussed in our investor statement on slavery from 2016, the practice of slavery is often hidden deep in the supply chain and can be difficult to detect even when suppliers have been audited.

It has been estimated that there are 40.3 million people in slavery conditions globally. Slavery is thus potentially more prevalent than ever before in human history, partly driven by migration, repressive regimes and conflict as well as environmental destruction. Of those, 24.9 million are in forced labour. The majority of these are found in Asia. It was also estimated there are 15,000 victims in Australia.

In 2017, the Commonwealth Government of Australia announced its intention to introduce a Modern Slavery Statement (similar to the UK MSA). Ausbil made submissions in support to government and also participated in various workshops with government, the opposition, businesses and NGOs. Following significant consultation, the Modern Slavery Act (MSA) was introduced to parliament in August 2018 and passed the lower house in September. Separately, a Modern Slavery Bill (MSB) passed both houses in New South Wales in June 2018. The intention of both is to mandate companies above a certain threshold level ($100m in consolidated annual revenue for the federal MSA and $50m in NSW) to make publicly available modern slavery statements on an annual basis. Those reporting federally will be exempted from the NSW MSB.

Comparing the UK MSA with the Australian MSA, one significant difference is that the Australian MSA, once passed both houses, will have mandatory reporting requirements (unlike in the UK where reporting organisations can opt out), covering 1) the reporting entity, 2) the structure of the operations and supply chain, 3) describing the risks of modern slavery practices in the operations and supply chains / any entities owned or controlled, 4) actions taken to assess and address modern slavery risks, including due diligence and remediation, 5) how effective those actions have been and 6) the process of consultation with entities owned / controlled and any other relevant information. The mandatory requirement and the fact that the Department of Home Affairs will control the publication of the MSA statements (which makes them comparable), means the Australian MSA has slightly more teeth than the UK version, where companies can opt out.

Ausbil will provide input and feedback on the guidance, which will provide further clarity on the specific reporting requirements. At the time of writing, we understand that companies need to report beyond tier one suppliers in the supply chain and we also understand that, based on the definition of 'operations', investors that meet the revenue thresholds will need to report on slavery risk in their portfolio holdings. The earliest we expect anyone would have to report is June 2020.

How can investors spot the risks and promote change?

ESG integration to Ausbil means a) better informed investment decisions and b) active ownership, or engagement on ESG issues. Human rights in supply chains has been a key engagement theme for Ausbil for years and earlier in 2018, Ausbil published an annual ESG engagement report, which detailed the engagement strategy, activities and outcomes in 2017.

Ausbil believes investors have an important role to play and can be part of the solution by encouraging companies to adopt industry best practice with a business rationale and with real life examples. To that end, Ausbil was a major contributor to a recent publication by the Responsible Investment Association Australasia (Investor toolkit – human rights with focus on supply chains).

Garment factory visit, Guangzhou, September 2016

A key issue with slavery, including forced labour, is that it is a profitable trade for the perpetrators and because of its illegality, it is often hidden deep down in supply chains. However, investors can still assess risks by focusing on a) high-risk sectors and b) identifying other risk flags. The Global Slavery Index estimated that $354 billion at-risk products are imported by G20 countries. The top products at risk of modern slavery are laptops, computers and mobile phones, garments, fish, cocoa and sugarcane. Other industries that are at high risk include mining, construction and building materials. In Australia, the obvious hot spots include, for instance, cleaners, agriculture and horticulture. Investors can also consider a number of other red flags, such as industries prone to sub-contracting, such as oligopolistic industries where there is competition on price and buyer-supplier relationships are highly transactional or where there is high pressure on shorter lead times. Other key indicators include complex and long supply chains with several intermediaries and where supply chains rely on a high proportion of migrant labour and others vulnerable to exploitation. At a more detailed level, other risk flags include labour recruitment agencies, employers withholding passports and forced deductions.

Promoting Human Rights within supply chains – key issues

Many human rights issues are often complex as well as highly intertwined and rather than focusing on modern slavery in isolation, Ausbil believes investors should encourage companies to make progress and adopt industry best practice on a number of underlying issues (these apply widely across many industries). Below is a short summary of some of those:

- **Map out and risk assess the supply chain:** A company that does not understand its own supply chain can be a proxy for poor management quality. We believe, as a starting point, companies need to map out their supply chains as far as possible beyond tier one suppliers, as many of the worst labour rights issues are occurring further down. Companies need to understand their supply chain, not just from a labour rights perspective but to be able to trace products, for example in the event of a product quality issue. Once mapped out, supply chains can be risk assessed by segmentation based on geography and various indices. Supply chains are becoming increasingly complex and it is difficult and costly to do due diligence on every supplier.

- **Focus on the ability to influence:** a responsible sourcing code of conduct might stipulate criteria that a supplier needs to live up to, but unless the buyer is in a position to influence suppliers they might not comply. Suppliers can be incentivised by rewarding those that improve with more business. Also, because of the complexity of global supply chains, consolidation can lead to both better visibility and oversight over the supply chain. Consolidation can also improve influence and incentivise suppliers to enforce the labour standards further down in the supply chain in tier two and beyond where a buyer has no direct relationship.

- **Reduce reliance on only audits and focus on building long-term strategic supplier relationships**: many companies publish audit statistics but often they only cover the first tier of the supply chain and not beyond where the worst issues are typically found, which means that audits might only be scratching the surface. Also, audits typically only give a snapshot view of a factory at a particular point in time. Audits, particularly pre-announced ones, can be a waste of money and of limited use when it comes to identifying forced labour and sexual harassment. The Rana Plaza building in Dhaka, Bangladesh, which collapsed in April 2013 and killed over 1,100 garment workers had been audited beforehand, but the audit scope did not cover the structural integrity of the building. Audits are a start and can be complementary, but it's what happens after the audit that is more important, namely the corrective action plan. Leaders are moving away from audits only and are focusing more on know your supplier (KYS) and spending time with key suppliers on a regular basis.

- **Staff training and alignment of KPIs between ethical sourcing and procurement teams**: while many buyers have responsible sourcing teams and codes of conduct for suppliers, our discussions with suppliers in Asia indicate that their goals are often misaligned with those of the procurement team (mainly on price). Combined with closer supplier relationships, alignment of responsible sourcing standards with buying teams, as well as training of buying teams (and suppliers and auditors) on responsible sourcing, can reduce the risk of subcontracting of production by suppliers and help them invest in factory improvements with greater confidence. Late changes to orders with demands for short lead times is a common issue that often leads to subcontracting or suppliers cutting corners on labour rights.

- **Increase transparency and collaboration**: leaders collaborate with other stakeholders to better understand the risk. Because many of the issues are of a systemic nature, they require a systemic approach and multi-stakeholder initiatives. Two key underlying issues across a wide range of sectors are the lack of living wages, namely a wage that meets basic needs and which may be very different from a local minimum wage, and freedom of association. The latter has been found to be a common denominator for many factory disasters, notably in Bangladesh where workers lack union representation. While individual companies might have limited ability to influence behaviour, shared best practice and a collaborative approach on key labour rights issues can result in change. For example, buyers from the same factory engaging with suppliers on the same issues. Many responsible sourcing initiatives have sprung up in recent years, particularly in the apparel industry, but not all have focused on transparency. Nevertheless, it is increasingly clear that transparency contributes to progress. For instance, the Better Factories Cambodia programme has disclosed factory compliance on critical issues for years, which has led to significant improvements in conditions.
- **Increased use of technology and grievance mechanisms**: In recent years, a number of third party platforms have emerged that improve transparency, facilitate mapping / risk assessment of supply chains and avoid duplicate audits (saves costs and reduces audit fatigue for suppliers). These can also be helpful tools for investors. Better use of technology can also address the limitations of audits, such as providing apps for workers to report on issues that might not be covered by a standard factory audit, such as sexual harassment. Companies with remedial plans for when human rights issues are found in supply chains can both create positive goodwill with external stakeholders and strengthen their ties with suppliers. Blockchain and other technology can also identify potential cost savings in the supply chain, which could potentially free up capital for higher wages.

Recent trends in responsible sourcing

A number of companies we spoke to in the most recent reporting season had begun to prepare for MSA reporting in Australia, before the Act was introduced in Parliament, starting with mapping out their supply chains and risk assessing suppliers. Leaders are also increasingly acknowledging the limitations of factory audits and certification. As discussed above, audits might identify issues but may not solve them because they fail to pick up on certain underlying issues. Failing to do so can result in supply chain disruption.

On a positive note, leaders are increasingly acknowledging that supply chain consolidation is key not only to reducing supply chain complexity but also to being able to resolve some of the key issues. Also, we're seeing increased collaboration between buying companies and between buying companies and NGOs.

Six to seven years ago, there was a trend of brand companies moving away from the use of agents to direct sourcing instead. While this reduces the fees paid to auditors and also improves the potential visibility over the supply chain, lately there has been a general trend of buying companies using agents for their sourcing again. The drivers seem to be pressures on shorter lead times and increased supply chain complexity.

One area where little progress has been made is the alignment of ethical sourcing and pricing despite years of focus on strengthening responsible sourcing practices. It is still common for suppliers to complain that deals are struck based on price only and cite conflicting interests between that and responsible sourcing demands.

Spotlight on Cambodia's garment industry and the prevalence of sexual harassment

The nature of the workforce in China is changing dramatically, which is adding to existing labour shortages and also continued wage inflation. As a result, Chinese manufacturers are increasingly focusing on automation, and manufacturing is also increasingly moving out of China to other south-east Asian countries, often to Chinese-owned factories. One such country is Cambodia where garments are a key export industry and employ approximately 600,000 workers, mainly migrant workers (85% of whom are women). The investment by China in Cambodia is increasing China's influence in the country.

Ausbil visited garment factories in Phnom Penh in September 2018. Common issues for buyers in Cambodia include electricity costs, lack of productivity and long lead times as well as the lack of vertical integration. Comparing Cambodia to Bangladesh, one major difference is that very few factories are owned by domestic operators in Cambodia (the complete opposite to Bangladesh). Yet, both countries share one common feature: the lack of vertical integration. In other words, both countries are mainly focused on the cutting and sewing stage of the supply chain, which means price, particularly labour cost, is a key differentiator. In contrast, China has significant vertical integration in the garment industry, which, along with superior productivity, is a key reason why China has maintained its competitiveness despite significant wage inflation for many years. In Cambodia, the average take-out pay is above US$200 per month, which is significantly higher than in Bangladesh and wages are expected to increase further in Cambodia.

An interesting initiative is the Action, Collaboration, Transformation (ACT), which is a collaboration of between approximately 20 global brands / retailers and trade unions to achieve living wages for workers through collective bargaining at industry levels. ACT has met with key players in Myanmar, Turkey, Vietnam and Cambodia. In Cambodia, ACT has engaged with employers and trade unions and a memorandum of understanding has been signed by all ACT member brands with the union IndustriALL. As part of ACT, brands will make countries with a collective bargaining agreement at industry level a preferred destination for sourcing and investment for a defined period of time. They also agree to incorporate higher wages as a cost item in their purchasing price calculations. In September 2018, ACT was preparing for a meeting with Cambodian partners to discuss a labour costing model, transparent ways of monitoring ACT member brand commitments and a joint conflict resolution approach.

The International Labour Organisation's (ILO) Better Factories programmes originated in Cambodia, which has traditionally been seen as relatively progressive on labour rights. This has historical roots from when Cambodia was open to advice from international stakeholders in the wake of the Pol Pot regime. For instance, the country is in advanced negotiations on national collective bargaining, one of the key underlying issues in Asian supply chains. However, at the time of writing, political uncertainty in Cambodia, following the dissolving of the opposition, might derail that process. In turn, that could make the supply chain more volatile again for those who source from there. Sanctions from overseas could also be a major blow to the industry.

Factory visit, Phom Penh, September 2018

Worker education on sexual harassment, factory visit in Phnom Penh, September 2018

Ausbil visited a number of factories together with CARE, which is an international development organisation fighting global poverty with a special focus on working with women and girls. CARE sheds light on the productivity loss from sexual harassment, which is rarely picked up by regular factory audits. Behaviours can include physical harassment and physical violence / assault, verbal and non-verbal harassment. CARE found, through interviews and focus groups, that nearly one in three female garment factory workers report experiencing sexually harassing behaviours. This also has a monetary cost: the estimated productivity cost of sexual harassment in the garment industry in Cambodia is US$89 million per year . This is equivalent to 0.52% of Cambodia's GDP in 2015. This is based on indirect costs of lower productivity, revenue loss and missed days of work based on both factory and worker perspectives. Presenteeism generated the highest costs to productivity. The data that found that women felt there was no other option for them but to attend work, despite harassment, as absenteeism was not an option. In addition to sexual harassment, CARE also focuses on hygiene and nutrition for workers through educational programs. Tangible benefits from improvements in these areas include reduced sick leave, lower absenteeism and better productivity. It has also reduced the number of workers fainting in factories, which has been a big issue in Cambodia in the past.

i Global Slavery Index 2018
ii Global Slavery Index 2018
iii https://insights.careinternational.org.uk/media/k2/attachments/SHCS_Full_Technical_Report_March_2017.pdf

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