MFS® Case Study

ESG in Action: Adidas

Separating the walk from the talk

May 2022

In brief

- When it comes to sustainability, it can be difficult to know when a company means what it says.
- In this case study, we discuss the importance of distinguishing sustainability-driven companies.
- We also describe how MFS has engaged with one company to gain a deeper understanding of its commitments.
- And we highlight how we are integrating this knowledge into investment decisions.

Was 2020 the year that sustainable investing really went global? Investors from around the world are taking a closer look at companies' sustainability credentials when putting their money to work.

In our view, environmental, social and governance (ESG) information is fundamental data that must be considered alongside all other material information. That is why our fundamental analysts and portfolio managers integrate their evaluation of a company or issuer's key ESG risks and opportunities into their overall security analysis and portfolio construction. They assess the extent to which they believe ESG factors are material to, and have an economic impact on, shareholder value.

One company, multiple facets

To gain a holistic view of a company's ESG assertions requires evaluation across the three ESG areas, as outlined below.

- Environmental – sustainable sourcing of raw materials, production processes, waste management
- Social – treatment of direct and supply chain workforce, data privacy, community relations
- Governance – management motivation and incentivization, board structure and independence

As the practice of evaluating companies' ESG policies has evolved, it has become clear that companies must become more aware of business practices beyond their direct operations. A company's share price and brand reputation can be materially affected by poor environmental and social practices within supply chains.

Why should companies and investors care about supply chains?

In July 2020, a UK-based online fashion retailer saw its share price nearly halved following a news report that it faced allegations of "slavery." One of the retailer's suppliers had subjected its workers to poor working conditions and paid them significantly less than the national minimum wage.[i] Despite the retailer receiving good scores from third-party ESG ratings providers, an independent report found that management was aware of the supplier's poor treatment of workers but failed to act.[ii]

This story obviously tarnished the reputation of the retailer, but it also impacted investors who owned the company. Following the story's publication, one of the company's largest shareholders sold almost all of its holdings, most of which were held in funds marketed as "responsible" investments. In total, according to Morningstar, 20 different sustainable funds held the stock.[iii] A number of online retailers including Amazon and ASOS also dropped the brand from their websites.[iv]

This example highlights a wider range of issues for investors to consider. Is there, or should there be, a premium paid for companies who are clearly and transparently meeting high ESG standards? How much does it cost for a company to improve its ESG performance, and what is the potential impact to revenue? What are the company's sustainability goals? How long will it take to meet them? What are the ESG metrics for measuring progress? Is management compensation linked to those metrics?

Underlying all these questions is the key question facing investors: How can you tell if a company's ESG credibility is real? The example above highlights a shortcoming of ESG ratings that is often overlooked: that they are largely backward-looking, especially in the case of "responsible" funds that use third-party ratings in their security selection process. Such backward-looking assessments are a questionable lens through which to look at future risks and opportunities. Fundamental company analysis is critical to understanding the potential materiality of ESG issues for investors who want to protect against negative outcomes and participate in the success that may follow improvements in a company's ESG performance. After all, it is easier to promise change than to deliver it.

Distrusting the hype, asking the hard questions, finding the evidence

Adidas says sustainability is integral to its business strategy, and in our view, the evidence to support this is clear. Important highlights include developing a formal Social and Environmental Affairs team in the late 1990s, helping to found the Fair Labor Association in 1999 and making its first shoe out of ocean plastic in 2015. In 2019, Adidas produced its first fully recyclable performance shoe.

EXAMPLES OF SUSTAINABILITY INITIATIVES OVER TIME

Source: Adidas

Within the company's own materials, investors can easily find details about its long-term sustainability vision, which focuses on ending plastic waste and achieving climate neutrality by 2050. It has already moved to using only sustainably sourced cotton and aims to replace all virgin polyester with recycled polyester by 2024.

EXAMPLES OF MEASURABLE MEDIUM-TERM TARGETS

Long-term vision	**End plastic waste**	**Achieve climate neutrality by 2050**
Measurable medium-term targets	▪ In 2020, produce **15-20m** pairs of shoes using Parley Ocean Plastic ▪ By 2024, replace **all** virgin polyester with recycled polyester	▪ By 2020, **35%** water savings at apparel material suppliers ▪ By 2020, **20%** energy savings and **20%** waste reduction at strategic suppliers ▪ By 2020, **3%** absolute annual reduction in CO^2 net emissions

Source: Adidas

The company has a strong history and measurable targets when it comes to sustainability, but is sustainability embedded in its culture, and does the company's supply chain meet its own high standards?

Digging deeper

During a 2020 call with Adidas management, MFS' equity, fixed income and ESG analysts had the opportunity to discuss sustainability directly with the CEO. This is one example of the additional value that an in-depth, fundamental research process can provide when we make investment decisions.

Adidas recognizes the conflict between creating sustainable products and processes and the unconstrained innovation often required to remain a leader in athletic performance. It understands that while a growing number of consumers consider sustainability when selecting products, most are still unwilling to pay a premium for it. These considerations have informed the company's long-term vision and expectations as they strive to develop sustainable products that can also deliver performance.

Adidas also understands the need for the whole company to be on board with sustainability. For example, when materials buyers opt for environmentally friendly options, designers need to incorporate them.

The company's ambitious sustainability goals come from the top of the organization, which appeals to an employee and customer base that is increasingly committed to sustainability. Adidas' ultimate goal is to make every product sustainable.

The company adheres to its long-term view while also understanding that scaling sustainability will be challenging. Its motivation, in our view, seems credible and authentic, and reflects the understanding that it cannot promote itself as a health and wellness brand if it does not display those values authentically. To create a lasting impact, it also appreciates the need to align with competitors in order to raise sustainability standards across the industry.

Supply chains are an area that many companies have paid little attention to over the past few decades, often at the expense of tail risks. Given its very large outsourced manufacturing footprint, the risks associated with supply chains loom large, particularly those related to labor practices. In this regard, we were impressed by Adidas' actions. It recognizes the magnitude of these risks to its brand and its business, and it has taken steps to manage them. It has its own in-house supply chain audit department, including on-the-ground teams in Asia and Eastern Europe, where supplier factories are located. Adidas conducts audits of all Tier 1 and most Tier 2 suppliers every two years at a minimum and requires suppliers to enact corrective measures in instances of noncompliance. It ended two supplier relationships in 2019 for compliance failures. In a bold move, Adidas has also started to disclose the names of its Tier 1, 2 and 3 suppliers. Given that supplier relationships often represent a competitive advantage, we believe this demonstrates that the company is serious about seeking to ensure an ethical supply chain.

Where do we go from here?

Adidas is communicating an authentic and well-aligned consumer message as it scales up development of the circular products that more customers are likely to demand after emerging from the current crisis.

Given the company's scale, its sustainability initiatives are meaningful, we believe. The depth, quality and duration of the supply chain work at Adidas will in our view help protect against human rights risks and increased environmental costs in the future. That said, Adidas' supply chains remain a big area of focus; while we appreciate that the company takes the issue seriously, we recognize that there is more it can do.

We continue to engage with Adidas and encourage change where we find room for improvement. We have discussed a number of other items with management, such as climate change and mitigating emissions. Adidas could benefit from upgrading internal systems and reducing its reliance on external consultants to gather emissions data. However, Adidas did commit to the Science Based Targets initiative in February 2020.[v] This is a strong first step, and we look forward to seeing the targets they set.

We believe the broader investment community has not yet realized the full potential of active ownership when it comes to creating long-term value for clients. We therefore encourage an open dialogue on the importance of active ownership and how all investors can be better owners and stewards of capital.

[i] https://www.independent.co.uk/news/uk/home-news/boohoo-leicester-factories-modern-slavery-boohoo-leicester-factories-modern-slavery-investigation-coronavirus-coronavirus-fast-fashion-a9602086.html

[ii] https://www.bbc.co.uk/news/uk-england-leicestershire-54292528

[iii] https://www.cityam.com/standard-life-aberdeen-offloads-boohoo-stock-over-leicester-factory-scandal/

[iv] https://www.forbes.com/sites/lelalondon/2020/07/08/why-has-boohoo-been-dropped-by-amazon-and-asos/

[v] https://sciencebasedtargets.org/companies-taking-action