

November 2021

One of the advantages of running portfolios as concentrated and long-term focused as ours is that we are able to dedicate a great deal of time to in-depth research on individual companies. This is an approach which carries across seamlessly into our work on ESG, and in recent months I have undertaken a large-scale project to hold an ESG-specific discussion with every company in our portfolios (which adds up to just over 70 companies). Of course these conversations do not function as a replacement for our ongoing engagements with management, but they do offer a useful supplement to ensure we remain up to date with our companies' thinking on the fast-moving world of ESG and, critically, ensure we understand the granular details of key aspects of their ESG strategies. Over the course of these calls a number of fascinating themes have begun to emerge, and here I'd like to look a little more closely at one in particular which is relevant for all companies across our portfolios, spanning a diverse range of industries from consumer goods manufacturers to data owners. This theme is the pressing need to measurably reduce greenhouse gas emissions, combined with the difficulty of doing so as the majority of these emissions tend to lie within the wider supply chain and therefore outside the company's direct control. In this piece I'd like to share a few examples of how this tension is beginning to impact our portfolio companies, and some of the potentially business model-fortifying approaches being developed and implemented to solve it.

I promise not to unleash a flood of technical data and acronyms, but I hope you'll permit me just a little jargon to set the scene. The most widely accepted global standardised framework to measure and manage greenhouse gas emissions ("GHGs") is the Greenhouse Gas Protocol, developed jointly by the World Resources Institute and the World Business Council for Sustainable Development, with the ultimate aim of restricting the global temperature increase to less than 1.5°C. Globally, private and public sector organisations are coming under pressure to contribute to this goal by committing to achieving "Net Zero", i.e. reducing to zero or offsetting all greenhouse gas emissions in their value chain, a process to be verified by various independent bodies such as Science Based Targets - and here's where the picture starts to get a little more complicated. The Greenhouse Gas Protocol divides emissions into three groups ("Scopes"), with Scope 1 being direct emissions from the organisation's own fuel combustion, Scope 2 being emissions from all purchased electricity, heat and steam, and Scope 3 being the huge and incredibly hard to quantify category of "value chain emissions". As an illustration, our portfolio company Heineken's Scope 1 and 2 emissions originate solely in its own breweries - the heat and electricity needed to actually brew the beer - and its Scope 3 emissions are everything else needed to get the bottled beer to the customer, from the raw material inputs to the transport to and from the brewery.

For the vast majority of companies, the bulk of their emissions fall into Scope 3: the CDP (formerly the Carbon Disclosure Project, a not-for-profit organisation administering various disclosure systems including arguably the most developed global supply chain analysis metrics) estimates that "supply chain emissions are on average 11.4 times higher than operational emissions". It's intuitive that this should be the case for data and technology companies with no manufacturing footprint (Experian, for example, calculates that just under 95% of its emissions are Scope 3) but in fact the same is true even for producers of physical goods. Remy Cointreau thinks that Scope 3 accounts for 73% of its total emissions; Diageo 86%, Heineken and Burberry each say 90%, Pepsico 93% and Unilever puts the figure at a whopping 98%. As an aside, you might be interested to know that the lion's share of Lindsell Train Limited's Scope 3 emissions are the investments in companies that we make on behalf of our clients, which will inevitably make up the majority of our own carbon footprint (being measured as I type).

So the conundrum here is that the biggest problem area is the one over which these companies have the smallest amount of control! Our portfolios tend to be much less carbon intensive than their benchmarks - Global has a carbon intensity of 35 (tons per \$1m revenues) versus 174 in the benchmark, UK 29 versus 138, and Japan 54 versus 163 - but this can and will be further reduced: 16 companies out of 24 in our Global Equity Fund and 14 out of 22 in our UK Equity Fund have already made Net Zero commitments, with an average target date of 2038 in Global and 2041 in the UK, and we expect more to follow in short order. Of course the goal of Net Zero is always achievable because companies commit to offset any emissions remaining after reduction and carbon capture efforts - but this could come at a considerable cost if the purchase of carbon offsets makes up too large a part of the solution. So the pressure is on for our portfolio companies to find ways to reduce emissions as much as possible to avoid a material financial impact. As of today it is difficult to quantify this exactly as there are a variety of ways of pricing carbon, but in every case the price is predicted to rise substantially between now and 2030. This will therefore impact all companies with a commitment to Net Zero, but for simplicity's sake in this note I've concentrated on manufacturers of physical goods as they tend to have the larger overall carbon footprint.

The first step for any company is to take a closer look at the value chain to identify what Diageo calls "hot spots", or particularly carbon intensive activities which must be adapted and altered. Not every company has reached the stage of being

able to calculate its total Scope 3 emissions, let alone conduct detailed analysis, but those which have done the work and are able to make disclosures often indicate that agricultural inputs and other materials such as packaging are the majority. For example, packaging and raw materials together account for almost 70% of Diageo's total Scope 3 emissions. Within packaging, transitioning from virgin to recycled plastic will be a key driver of emission reduction - Unilever estimates that recycled plastic has a 50% lower greenhouse gas footprint than virgin plastic. Making this switch also has the happy side-effect of reducing the burden of incoming plastic taxes, for example the UK's Plastic Packaging Tax, which will be in force from April 2022 and levying a hefty charge on plastic packaging with a recycled content of less than 30%. We were impressed with the work that our portfolio company AG Barr has done on this front - by 2022 every bottle the company produces will be made from 100% recycled material.

Arguably raw materials are the more difficult contributor to tackle - certainly for many companies they make up the bulk of Scope 3 emissions. Unilever has identified this as the "primary focus of [its] emissions reduction efforts over the next decade", something which will necessarily involve engaging with and influencing suppliers. Burberry, too, highlighted that "sourcing and production of raw materials" accounted for the majority of its Scope 3 emissions. So a clearer picture of the areas of focus is beginning to emerge, but it's impossible to even begin to tackle the issue without first establishing the nature of these suppliers. In the context of global manufacturing, the idea of a "supplier" conjures up images of enormous factories pumping out raw materials into yet more factories putting the materials together! There is some truth to this, for example Coca-Cola counts the emissions of its large, often listed bottlers as part of its own Scope 3 and Unilever highlights that within its total 60,000 suppliers, just 300 are accountable for two thirds of its Scope 3 emissions.

But these are only one piece of the total, and taken as a whole, the supply chain of a global manufacturing company is considerably more complex and with a lot more exposure to small operators than one might imagine. Pepsico counts 250,000 people in its total agricultural supply chain, with 40,000 farms supplying its farmer-sourced ingredients (i.e. those not bought via a wholesaler or other middleman). Unilever buys raw materials from 1.5 million farmers, often via aggregators. And in Africa alone, Diageo purchases raw materials from 80,000 smallholder farmers. Burberry relies on a network of often tiny specialist suppliers, such as a 200 year old mill in Scotland which has been supplying the company's cashmere scarves for over a century. Any emission reduction requirements will have a far larger impact on these tiny suppliers, most of whom are too small to make changes without assistance.

It's therefore far too simplistic to set a target, issue an edict from on high and expect suppliers to fall in line across the board. Encouragingly, this is something that all of our portfolio companies seem to understand well and every one of the companies I spoke to acknowledged that they have a responsibility to support their suppliers - not least because it's very much in their interests to ensure that links in their supply chain don't fail, whether from an increased emission reduction burden or the impact of climate change (such as water scarcity or soil erosion) making farming unsustainable. This picture becomes even more complicated when one digs a little deeper into the social breakdown of these suppliers, e.g. Diageo told us that the "vast majority" of smallholder farmers are women, leading to all of its supply chain engagement with its network of smallholders being "inclusive by design" e.g. working with Care International to ensure that all nuances of the situation have been grasped and taking steps such as arranging meetings at a time women can attend. So what might support for smallholder farmers look like? Unilever is currently running or participating in smallholder projects including 600,000 farms globally, with an emphasis on teaching soil preservation methods to maintain productivity and reduce carbon intensity. One such project in Madagascar provides tools and educational materials to farmer field schools trying to improve vanilla productivity - a key crop for Unilever as it's used in all its ice cream brands. Diageo runs a similar network of projects, with the aim of supporting 150,000 smallholder farmers by 2030.

Closer engagement and a sense of responsibility also emerged as a theme at Burberry, which mentioned that where relevant they "provide technical and strategic support" to their suppliers, helping to share the load with smaller partners like that Scottish mill. CFO Julie Brown highlighted that Burberry's heritage and longstanding supplier relationships, features of the company that we at Lindsell Train have always prized, are great assets in this regard as the company starts from an existing base of trust, open dialogue and collaboration. I was particularly intrigued to see evidence of increasing transparency within the notoriously secretive wider luxury fashion industry - Burberry gave us details of their new partnership with the Apparel Impact Institute (AII), Stella McCartney and Kering, the parent company of Gucci. Informally called "The Italy Project," its overarching aim is to improve the environmental footprint of Italy's luxury fashion supply chain, with the largest goal being to build a platform for manufacturers to coordinate, fund, and scale environmental programmes with "measurable impact". Critically, the three brands will continue to collaborate with each other and their suppliers to implement the solutions they have developed, harnessing the power of shared resources to improve their approach. This will be a long-term project, beginning with 20 Italian manufacturing facilities but expanding further over the years.

From a financial perspective the benefits are evident - Burberry of course wants to avoid having to pay for carbon offsets as much as possible - but arguably a "shared goal" of carbon reduction, prompting increased dialogue and collaboration between both suppliers and other industry participants, will bring economies of scale within the technology and "best practice" development process and help to strengthen Burberry's overall supply chain, minimising disruption and improving reliability.

Collaborations such as the Italy Project necessarily open the door to more scrutiny, which we believe could be helpful in identifying and correcting potential inefficiencies. And innovation within the company itself will also continue to play a large part in finding solutions – Japanese consumer goods manufacturer Kao, held in both our Global and Japan portfolios, reports that almost 40% of its Scope 3 emissions are from “use of products”, i.e. the energy and water utilised when consumers use its products. Several of its products have been reformulated to tackle this, such as ultra-concentrated laundry detergents requiring smaller quantities of water to rinse – which has the dual effect of advancing Kao’s progress towards its Net Zero goal and keeping its brands fresh, relevant and appealing to consumers. Diageo has also confirmed the power of collaboration and innovation with the launch of its “Diageo Sustainable Solutions” programme, open for innovators to submit ideas and solutions which the company can then support with funding and expertise. The first round received 300 applications so there are certainly promising ideas out there to take advantage of!

We recognise that these initiatives are at a very early stage, but I was encouraged by the universal understanding across our portfolio companies that innovation, collaboration, dialogue and increased transparency is going to be the way forward. In the words of Diageo, “everyone is in everyone else’s Scope 3”, so more collaboration will mean more convergence over time. It will also help to avoid the potential problem of double-counting emissions and ensure a clearer, more accurate picture. And there are distinct advantages to assisting existing suppliers with carbon reduction goals rather than simply switching to new suppliers - firstly, long-standing supplier relationships are an asset worth preserving (in the words of Fever Tree, they bring trust and stability, which then tends to allow for more productive “frank conversations” around carbon reduction initiatives). Secondly, terminating contracts with quality suppliers means losing them to competitors who are less concerned with climate change. But most importantly, jettisoning suppliers doesn’t actually solve the global problem as these smaller players are much less likely to change for the better without having access to the support and resources of the likes of Unilever. Of course, there’s a cost involved in providing this support, but we view this as our portfolio companies making an investment in the health and strength of not only the supply chain but the wider world.

Finally, we note that there are more and more overarching initiatives designed to coordinate and improve supplier engagement, e.g. the CDP’s annual “Supplier Engagement Rating” which evaluates the breadth and quality of corporate supply chain engagement on climate issues, and lists the highest-rated companies in the Supplier Engagement Rating Leaderboard, indicating their more advanced approach to supplier engagement. Of a total of 400 companies on the Leaderboard, 15 are in Lindsell Train portfolios - an encouraging figure as a starting point! Just as we welcome more intra-industry collaboration and dialogue, as these initiatives gain pace we would hope they bring further benefits, allowing companies to learn from and hold each other to higher standards. We will be closely monitoring via ongoing engagement and data collection how our portfolio companies’ initiatives continue to develop against this backdrop, reducing the need for carbon credit purchase as much as possible but also using the increased scrutiny to improve efficiency, perhaps developing new technology or techniques. Ultimately their challenge is to shore up and future-proof their brands and supply chains, whilst acting as responsible stewards with the ability to make a positive global impact.

Madeline Wright, Deputy Portfolio Manager

Lindsell Train Ltd

Sources:

Conversation with Diageo plus Diageo published materials including their ESG Reporting Index 2021

Conversation with Unilever plus Unilever published materials including Climate Transition Action Plan, Unilever, March 2021

‘Unilever to demand all suppliers pay a living wage’, Charlie Hart, Supply Management (CIPS), January 2021

‘Unilever outlines plans to halve supplier emissions by 2030’, Sarah George, September 2021, edie newsroom

Conversation with Pepsico plus Pepsico published materials including their 2020 Sustainability Report: Focus Areas CLIMATE, and ‘PepsiCo unveils ambitious new agricultural goal’, April 2021, www.pepsico.com.

CDP, ‘Transparency to Transformation: A Chain Reaction’, Global Supply Chain Report 2020

LTL proprietary ESG spreadsheet data

Conversations with Experian, Burberry, Remy Cointreau, Heineken

Risk Warning

This document is provided for information purposes only and is intended solely for use by professional investors and advisors. Specifically, it is not intended for, and is not suitable for, those who would be categorised as Retail Clients, and it should not be relied upon by private investors.

Past performance is not a guide or guarantee to future performance. Investments are subject to risks and may also be affected by exchange rate variations. The investment value and income may go down as well as up. Investors may not get back the amount they originally invested.

© 2024 Morningstar, Inc. All rights reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete, or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

The MSCI information may only be used for your internal use, may not be reproduced or disseminated in any form and may not be used as a basis for or a component of any financial instruments or products or indices. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each other person involved in or related to compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties (including, without limitation, any warranties of originality, accuracy, completeness,

timeliness, non-infringement, merchantability and fitness for a particular purpose) with respect to this information. Without limiting any of the foregoing, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including, without limitation, lost profits) or any other damages. (www.msci.com).

"FTSE ®" is a trademark jointly owned by the London Stock Exchange Plc and The Financial Times Limited and is used by FTSE under licence. "All Share" is a trademark of FTSE. FTSE does not sponsor, endorse or promote the content of this communication.

Opinions expressed whether in general or both on the performance of individual securities or funds and in a wider economic context represents the view of the fund manager at the time of preparation and may be subject to change without notice. It should not be interpreted as giving investment advice or an investment recommendation. No part of this document may be copied, reproduced or distributed to any other person without prior express written permission from Lindsell Train Limited.

Copyright Lindsell Train 2024.
LTL 000-257-8 11 November 2021.

Lindsell Train Limited
66 Buckingham Gate
London
SW1E 6AU
UNITED KINGDOM

Tel. 020 7808 1210
Fax. 020 7808 1229
www.LindsellTrain.comInfo@lindselltrain.com

Please refer to Lindsell Train's Glossary of Investment terms [here](#).