

SUPPLY CHAINS



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1. ABOUT THIS E&S BRIEFING NOTE

This E&S Briefing Note is designed to help fund managers quickly familiarise themselves with the topic of environmental and social (E&S) risk in supply chains as it relates to investment. It is not intended to be a detailed technical guidance document.

Additional considerations

Formal technical guidance is provided at the end of this Note and in [Downloads & Reference Materials](#), including International Finance Corporation's (IFC's) 2012 Performance Standards (of which PS 1, 2 and 6 are particularly relevant to supply chains).

This E&S Briefing Note provides an overview and general guidance. Fund managers should carefully consider each company based on its specific characteristics and circumstances including scale, location, technology, management capacity and commitment, and track record. Risks, impacts and opportunities relating to a particular company or sector can also change over time for a number of reasons (e.g. changes in the applicable laws and regulations or in the type of the company's activities or assets). Fund managers may need to engage external experts in some situations (see Advice for fund managers section below).

Sustainability in the supply chain has become an increasing area of focus for large companies or off-takers caused by competitive pressures arising from new E&S regulations, labour standards, biodiversity impacts, energy costs, and government and consumer demands. Of particular note are the expectations around supply-chain risk and management that have emerged from the [UN Guiding Principles on Business and Human Rights](#), which has increased scrutiny of supply-chain labour practices in particular. The [UK Modern Slavery Act 2015](#) has also played a significant role in drawing the attention of many companies / investors to the risks associated with forced and slave labour in emerging markets.

2. INTRODUCTION

All companies have supply chains. However, some have more tiers and are more complex than others. Against a backdrop of increasing scrutiny over supply-chain E&S concerns, ensuring that a company understands its supply chain, has assessed the type and location of E&S risks, and is able to manage (or exclude) potential issues within that chain, is becoming increasingly important as a risk-mitigation and – potentially – a market-access strategy.

Supply-chain risks encompass a broad range of E&S issues, including: labour and working conditions, occupational and community health and safety, biodiversity, pollution prevention and stakeholder relations. In some instances, particularly where supply chains impact indigenous peoples or other vulnerable groups, are labour intensive, or where the chains source materials from fragile and conflict-affected areas, human-rights risks may be evident. There are significant opportunities for companies to drive improved efficiency and better business practices among their suppliers (for example, by requiring better labour and employment practices), which can result in benefits to them as the customer.

A particular challenge for all companies, and their investors, is the extent to which they can influence supply-chain practices beyond tier-one suppliers. Good practice increasingly involves mapping supply-chain risks thoroughly – so that the type and significance of E&S risks are understood – and then to make a decision about how best to address material business risks (for example, the risk of forced or child labour), which may include removal of some suppliers where leverage and influence are limited and impacts are significant.

In an increasing number of industry sectors (including agriculture, forestry, mining and textiles), there are voluntary sustainability standards and chain of custody assurance programmes that provide increased comfort on the presence of good E&S practices in supply chains (see [Standards Map](#)).

3. WHY COMPANIES AND FUND MANAGERS SHOULD ADDRESS THIS TOPIC

3.1 Risks for the business

Failure to effectively manage E&S aspects of the supply chain can result in risk / adverse impacts on companies, such as:

- Increased disruption to supply of goods and raw materials, and associated operational impacts.
- Loss of brand value, customer and consumer confidence, as well as potential loss of access to some markets and buyers.
- Difficulties accessing additional investment and capital.
- Increased regulatory requirements and potential loss of markets.
- Feelings of opposition and grievance, which can impact the social licence to operate within communities.
- Reputational damage.

3.2 Opportunities for the business

Implementing changes to supplier behaviour and approaches to E&S can result in a range of investor benefits over the short, medium and long term. Potential benefits include:

- Reduced costs and enhanced efficiency and productivity.
- Process and product innovation.
- Access to new markets.
- Improved working conditions for employees of suppliers can reduce staff turnover and improve productivity, and quality and reliability of delivery.
- Increased company value and improved opportunities for exit.

4. ADVICE FOR FUND MANAGERS

Companies and investors should understand the main E&S risks within their supply chains. Investigating and managing supply-chain risk are relevant to every company in every sector. However, sectors and activities with particularly complex and / or high-risk supply chains include:

- Agriculture and aquaculture.
- Fisheries.
- Food and beverages.
- Textiles and garments.
- ICT.
- Forestry and plantations.
- Healthcare.
- Hospitality.
- Infrastructure (especially via EPC contractors).
- Manufacturing (e.g. cement, pulp and paper mills, refineries).
- Mining.
- Oil and gas.
- Retail.

Fund managers should assess whether an investee company has policies and systems in place which (i) clearly explain the E&S requirements that suppliers are to meet via a procurement policy (e.g. supplier code of conduct); (ii) enable it to assess E&S risks throughout its supply chain and whether it has in place a mechanism to improve poor practices where they may be evident, or failing this, and where significant in nature, to exit the relationship.

Fund managers should consider using an expanded due diligence approach to investigate supply-chain E&S risks when assessing investments, particularly those in the above sectors. In the expanded due diligence model, the traditional scope of E&S due diligence is widened so that the investor also assesses the effect the investee company can have through its own business relationships and how the investee company can affect the E&S performance of other actors in the supply chain. Furthermore, investee companies could be encouraged to adopt internationally accepted standards and codes, such as SA8000, to demonstrate their commitment and ability to manage the sustainability of their supply chains.

Business integrity in supply chains

Fund managers should review whether companies have robust policies in place to ensure that supplier contracts are awarded on commercial merits alone, and that business integrity practices are upheld in dealing with suppliers.

Environmental impacts in supply chains

Certain types of supplier may generate significant environmental impacts, particularly those in the extractive, agricultural / forestry or manufacturing sectors. Environmental challenges in these sectors include impacts on natural resources (habitat, water and forests etc), high energy demand (with associated greenhouse gas emissions), significant pollution and waste management outputs.

Ultimately, the same issues associated with pollution prevention, biodiversity conservation and resource efficiency need to be assessed at the investee *and* associated supplier levels. These topics are covered in other CDC E&S Briefing Notes.

Social impacts in the supply chains

In the due diligence process, issues surrounding labour standards and working conditions (in particular, the use of child labour and forced labour), occupational health and safety, and community health and safety and security, need to be considered among suppliers as well as potential investee companies. In some instances, supply chains may impact indigenous peoples or other vulnerable groups, or may source from fragile and conflict-affected areas. In such situations, enhanced environmental and social due diligence should be undertaken and particular consideration should be given to human-rights risks.

As supply chains typically become more fragmented, informal and basic with each step back from the ultimate buyer, conditions for workers also typically become poorer. At the same time, scrutiny of company supply chains by the media, NGOs and regulators is increasing and the case for fund managers to help investees understand and assess supply-chain risks becomes increasingly evident.

More broadly, fund managers should also assess whether there is scope to rationalise the company's supply chain, to achieve operational efficiencies or to reduce exposure to certain types of risks.

5. FURTHER RESOURCES

5.1 Further information and guidance

- [IFC 2012 Performance Standard 1: Assessment and Management of Environmental and Social Risks and Impacts.](#)
- [IFC 2012 Guidance Note 1: Assessment and Management of Environmental and Social Risks and Impacts.](#)
- [IFC 2012 Performance Standard 2: Labor and Working Conditions.](#)
- [IFC 2012 Guidance Note 2: Labor and Working Conditions.](#)
- [IFC 2012 Performance Standard 6: Biodiversity Conservation and Sustainable Management of Living Natural Resources.](#)
- [IFC 2012 Guidance Note 6: Biodiversity Conservation and Sustainable Management of Living Natural Resources.](#)
- [Investments in the Agricultural Value Chain: Expanding the Scope of Environmental and Social Due Diligence.](#)
- [United Nations Global Compact Sustainable Supply Chains: Resources and Practices.](#)
- [UN GPs on Business and Human Rights.](#)
- [OECD-FAO \(2016\) Guidance for Responsible Agricultural Supply Chains.](#)
- [UK Modern Slavery Act 2015.](#)
- [McKinsey & Company: Starting at the source – Sustainability in supply chains.](#)