Whitepaper on Arisaig Stewardship Module

"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

Source: CartoonCollection.com

Contents

Introduction:

ESG integration has been an integral part of our investment process since the beginning of Arisaig. How this has been executed has evolved over time, but the rationale and principles have remained constant. Companies that want the best access to the necessary natural (the 'E'), human (the 'S') and capital (the 'G') resources must adopt above-average ESG practices.

Skipping over the 'why', this whitepaper we will focus on the ways in which we have updated 'how' we do this, running through the current and ongoing systems development to help us improve our three-stage ESG approach: Understand → Integrate → Engage. This is the latest stop on the long journey towards maintaining the best practices within our space and delivering the maximum value-add to both our investors, our investee companies and hopefully to society at large.

We have recently created four new engagement modules on our internal 'Hummingbird' system designed to support the ESG research process we complete for each company. We lay these out below – numbered in gold.

Arisaig Company-Level ESG Process

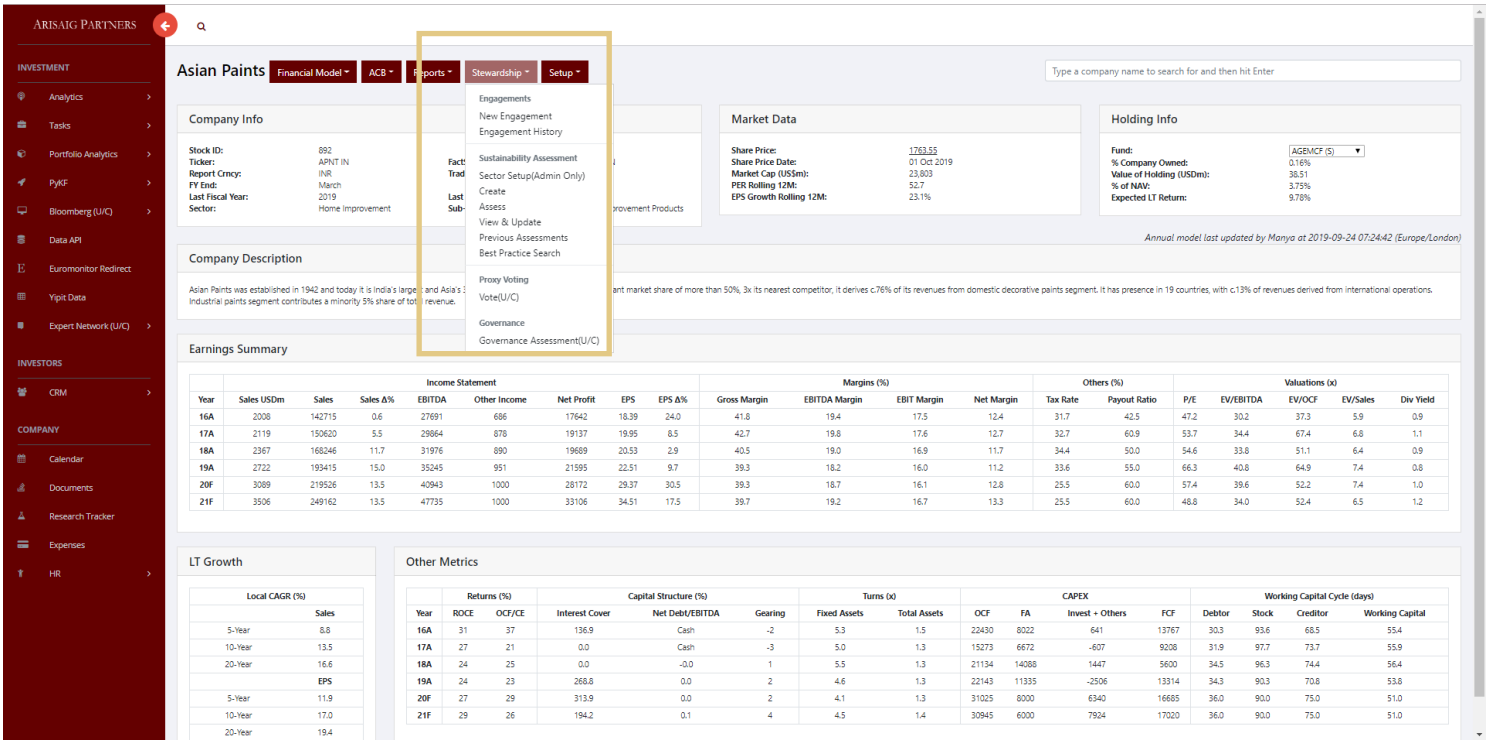
	Governance	Environment / Social
	1 **Corporate Governance Checklist**	2 **Sustainability Risk Management (SRM) Framework**
Integration	*All companies are run through our internally-developed 66-item checklist that covers shareholders rights, transparency and related parties, audit and accounting, board oversight, and executive oversite and compensation.*	*All companies are measured and scored against an internally-developed framework that identifies the 5-10 most material 'E' and 'S' risk issues, the best practice in risk management and the supporting metrics at a sub-sector level.*

Output	• *Score out of 100;*
	• *Identification of red-flag governance issues;*
		• *Sustainability Rating from A-E for risk management approach. This is determined by scores across 3 equally-weighted dimensions:*
		  • *Strategy*
		  • *Disclosure*
		  • *Performance*

3 Engagement	*Engagement focused around issues where company is not performing in line with global best practice.*	*Engagement focused around issues where company is not disclosing satisfactorily and/or where policy fails to meet expectations.*
4 Proxy Voting	*Use shareholder votes to vote behind the best practices within the Checklist and engage with company where we see gaps*	*With the scope to propose agenda items limited in emerging markets, the proxy vote has less relevance here, but where possible, we will use the opportunity to push towards global best practice.*

New Modules:

Within each company's microsite on Hummingbird we have a 'Stewardship' tab which houses each of our new modules that are designed to enhance our ESG integration and engagement process.



Running through each of these modules individually:

1) Corporate Governance Checklist

The first stage of our ESG process is to address corporate governance, as this can be an early decision signal.

We approach this through an internally-developed global best-practice checklist, which identifies the most important issues that our companies should be addressing. In many cases this is over and above what is mandated by local regulation.

The checklist currently covers 70 items spread across shareholders rights, transparency and related parties, audit and accounting, board oversight, and executive oversight and compensation.

Each issue is weighted between one (desired) and three (critical/red flag), based on a consensus amongst the research team. They are then scored in a binary fashion by the covering analyst (i.e. a yes/no answer). If a red flag issue (e.g. sizeable related-party transactions) is identified within a company, the team will conduct careful additional research and require a high level of conviction for it to even be considered as an investment candidate.

Sample Summary Output of Corporate Governance Checklist

	Raw Score	Out of	%	Weigthed Raw Score	Out of	Final Score (%)
Overall CG Score	**51**	70	73%	109	141	**77%**
Shareholder Rights	11	12	92%	25	26	**96%**
Transparency & Related Parties	9	13	69%	24	31	**77%**
Audit & Accounting	11	14	79%	21	26	**81%**
Board Oversight	10	15	67%	20	28	**71%**
Executive Oversight & Incentivisation	10	16	63%	19	30	**63%**

This has been moved to an online version, allowing us to easily track across companies and across time. This will also help us to track progress on key governance engagement objectives over time (more on this in the Engagement Module section).

2) Sustainability Risk Management Framework (SRM)

Given the distinct nature of sustainability issues – they are typically more qualitative and nuanced - we approach this via a separate 'Sustainability Risk Management Framework' (SRM).

Within the world there are numerous environmental and social sustainability concerns that one can attempt to understand and assess. However, there is growing evidence that a more focused, materiality-based approach is the most effective at delivering specified outcomes and subsequent returns.

On the outcomes side, it allows both investors and companies to concentrate on the most important deliverables and avoid the distraction of the multitude of long-tail risks that can affect any business. On the returns side, recent studies[1] have evidenced a significant positive outperformance of companies that have strong ratings on material issues versus those that do not. Further supporting the case, the same relationship was not to be found for companies that scored better on immaterial issues.

With a greater focus on materiality than our previous approach, we set about creating a new framework that took a more bottom-up view of the sustainability issues that really matter for each sub-sector. We began by taking the Sustainable Accounting Standards Board's (SASB) materiality matrix (the same used in the aforementioned study). Through 11 industry working groups, made up of corporates, investors and NGOs, SASB has mapped out the most financially material ESG risks (typically 5-7) for 77 sub-industries – see below the simplified sector-based view of this.

[1] *Khan, Mozaffar and Serafeim, George and Yoon, Aaron, Corporate Sustainability: First Evidence on Materiality (November 9, 2016). The Accounting Review, Vol. 91, No. 6, pp. 1697-1724*

SASB Sector Materiality Map (Arisaig Sectors Highlighted in Gold)

Dimension	General Issue Category	Consumer Goods	Extractives & Minerals Processing	Financials	Food & Beverage	Health Care	Infrastructure	Renewable Resources & Alternative Energy	Resource Transformation	Services	Technology & Communications	Transportation
Environment	GHG Emissions											
	Air Quality											
	Energy Management											
	Water & Wastewater Management											
	Waste & Hazardous Materials Management											
	Ecological Impacts											
Social Capital	Human Rights & Community Relations											
	Customer Privacy											
	Data Security											
	Access & Affordability											
	Product Quality & Safety											
	Customer Welfare											
	Selling Practices & Product Labeling											
Human Capital	Labor Practices											
	Employee Health & Safety											
	Employee Engagement, Diversity & Inclusion											
Business Model & Innovation	Product Design & Lifecycle Management											
	Business Model Resilience											
	Supply Chain Management											
	Materials Sourcing & Efficiency											
	Physical Impacts of Climate Change											
Leadership & Governance	Business Ethics											
	Competitive Behavior											
	Management of the Legal & Regulatory Environment											
	Critical Incident Risk Management											
	Systemic Risk Management											

Source: SASB, 2018

Deep red indicates issue is likely to be material for >50% of industries in sector; Light red indicates material for <50% industries; blank indicates immaterial for any industries in the sector

We adapted this first by re-mapping industry classifications to our own internal sector taxonomy. A sample of these is shown below. This then established an independently verified base of key issues (and supporting metrics) for us to build upon.

Taxonomy Adjustment SASB -> Arisaig (Sample)

SASB Industry	Arisaig Sector
Houshold and Personal Products	Home and Personal Care
Restaurants	Foodservice
Building Products and Furnishings	Home Improvement
Apparel & Accessories	Apparel and Footwear
Food Retailers and Distributors	Grocery Retail
Multi- line & Speciality Retailers	General Retail
Meat, Dairy & Poultry	Food & Beverage
Processed Food	
Non Alcoholic Beverages	
Alcoholic Beverages	Alcoholic Beverage
Drug Retailers and Convenience Stores	Specialty Retail
Health Care Distribrution	Consumer Healthcare
Ecommerce	Digital Platform
Software and IT	
Internet Media and Services	

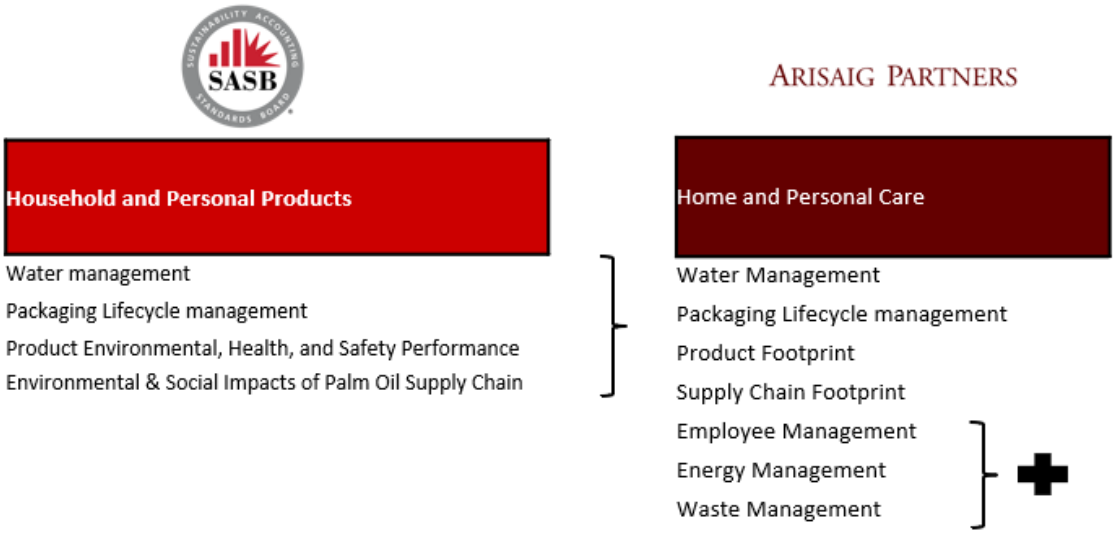
On top of this we added in additional material risks that we believed were overlooked. These came from a combination of our assessment of the key risks identified by the leading players within each sub-industry and our internal understanding of material issues on the ground in emerging markets. Below we show an example of this risk re-mapping process for the Home and Personal Care (HPC) sector. We added in three additional issues that we believed were critical to the long-term success of HPC companies:

a) **Employee management** – an empowered and engaged workforce is critical for most companies. Diversity becomes particularly important for HPC where the majority of consumers are female.
b) **Energy management** – any manufacturing business has a carbon footprint (both direct and indirect) that it must be accountable for.
c) **Waste management –** as the fallout from the 2001 Mercury poisoning incident involving Hindustan Unilever demonstrated, ill-treatment of manufacturing waste can result in significant environmental and societal harm. This in turn leads to long-lasting reputational damage to a firm and its brands.

Finally, we weight these issues using the average weighting of each industry sub-team member. This

helps us prioritise the issues that the sector specialists deem most material.

Arisaig Sector-Based Risk Mapping: Home and Personal Care



Using the same resources, we define our internal expectations for companies in managing each of these material risks, including proposals for reporting metrics within each.

Combined, this forms the backbone of the SRM that we apply to each company. The covering analyst has the discretion to adjust the key issues and weightings for companies that span industries (e.g. Hindustan Unilever operating across 'Hope and Personal Care' and 'Food and Beverage').

SRM Setup Page for Hindustan Unilever

Sustainability Setup

Default Key Issues for Home and Personal Care

Choose Fiscal Year

Key Issues	Type	Subsector	Industry Weightage	Company Weightage	Include/Exclude
Energy Management	E	Home and Personal Care	10 %	10.0 %	✓
Employee Management	S	Home and Personal Care	15 %	15.0 %	✓
Supply Chain Footprint	E/S	Home and Personal Care	20 %	20.0 %	✓
Product Footprint	E/S	Home and Personal Care	20 %	20.0 %	✓
Packaging Life cycle management	E	Home and Personal Care	15 %	15.0 %	✓
Water Management	E	Home and Personal Care	10 %	10.0 %	✓
Waste Management	E	Home and Personal Care	10 %	10.0 %	✓
Total			**100%**	**100.0%**	

Search for additional issues

Choose one:

Save

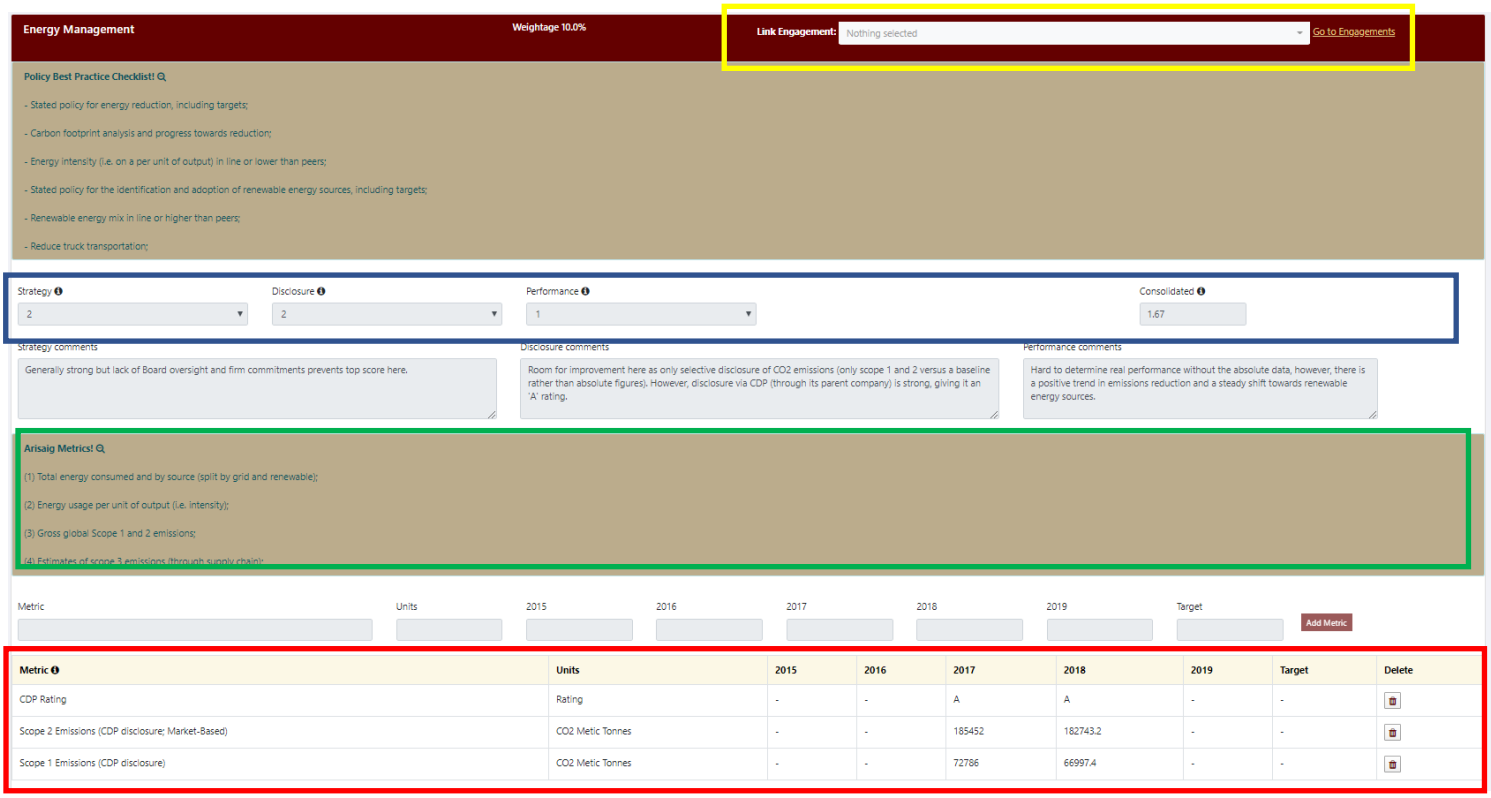
Once the setup for each company is complete, we run through the process of rating its management of each risk across three equally-weighted dimensions:

a) **Strategy and Governance**– does the company have a strategy in place to manage this risk and is it suitably ambitious in its scope (i.e. turning the risk into an opportunity)? Is this overseen by the Board and linked to management remuneration?
b) **Policy & Disclosure** – how clear and effective is the company's policy around this issue and are they disclosing their approach in sufficient detail?
c) **Performance** – how well is the company performing against its objectives to manage this risk?

A score is entered between 0 and 3 (see blue box in snapshot below) with the help of a scoring guide to ensure consistency. We include commentary on each score to give it context and also allow for comparisons across companies, geographies and timeframes (see green box). All relevant metrics are also captured to help guide the performance score, benchmark each company and track progress over time (see red box). Finally, we tag in any associated engagements we have had or are intending on having with the company to allow us to better track progress (yellow box).

The benefit of this approach is that it does not require full company disclosure to register a score. This is important as in emerging markets, lower disclosure rates can render data-based approaches less effective.

SRM Assessment Page for Hindustan Unilever



The scores across these three dimensions feed into a consolidated 'Risk Management Score' (out of 9) and in turn a 'Risk Management Rating' (A-E) for each company (see red box below). We display a

full breakdown of the score in the Summary Table (shown below), which allows analysts to focus their efforts on the weak spots of a company. Equally, we are able to identify (and search via a separate 'Best Practice Search' tool) the companies within each industry that score best on each issue. Finally, a commentary box must be completed to summarise the companies SRM score (see green box below), highlighting key areas of strength and weakness.

Of course, this will not capture all of the potential environmental and social risks and shortcomings of a business. However, by focussing on the issues that are most important to value creation within each sector and company, we hope to remove the friction in the flywheel process described above: by understanding the key issues better, we should be able to both measure their impact more effectively and target our engagement efforts to where we can have the greatest effect.

SRM Summary Page for Hindustan Unilever

Summary	Comments
Company : HINDUSTAN UNILEVER LTD	Hindustan Unilever has one of the leading sustainability practices withing FMCG companies in both India and the emerging world. Its employee management practices - in particular gender opportunities - are best in class. However there are still areas which appear vulnerable, in particular the exposure of the company to changes in regulation around single-use plastics.
Subsector : Home Care	
Year : 2019	
Risk Management Score : 4.9	
Risk Management Rating: C	

Key Issue	E or S	Weightage	Strategy	Policy/Disclosure	Performance	Consolidated Score
Energy Management	E	10.0%	2	1	1	●
Employee Management	S	15.0%	3	2	2	●
Supply Chain Footprint	E/S	20.0%	2	2	2	●
Product Footprint	E/S	20.0%	1	1	1	●
Packaging Life cycle management	E	15.0%	2	1	1	●
Water Management	E	10.0%	2	1	1	●
Waste Management	E	10.0%	2	2	2	●
Grade			**B**	**C**	**C**	**C**

Legend: Consolidated Score			
0	1	2	3
●	●	●	●

3) Engagement Tracker

A critical step in our ESG process is to fill the gaps in our understanding identified through the CG Checklist and SRM, and if necessary, to push the company towards better practices in the future.

Although we have been engaging with companies since the very beginning of Arisaig Partners, we lacked the necessary tool to audit the process. The Engagement Tracker was launched to rectify this. Aside from logging all our engagements and tracking progress, we hope to become more effective in proactively establishing engagement objectives across teams.

Engagement Areas and Issues

We define an engagement as: an interaction with a company that has an explicit, predefined objective. This is distinct from a routine company meeting in which we discuss the latest strategy or hear about ESG developments.

Our engagements can be broken down into three broad areas:

Engagement Area	Description	Examples
1 Strategy	Engagement in which we seek to steer the long-term strategic direction of the business	• Pushing for change in company's digital strategy • Introducing a marketing agency to improve branding
2 Governance	All matters related to the governance policy of the company and the alignment of interests between all stakeholders in the business.	• Shareholder rights • Executive remuneration • Board oversight
3 Sustainability	Everything related to a company's ongoing management of, and access to environmental and social resources.	• Probing a company's approach to e.g.: ○ Climate risk ○ Health and wellness ○ Employee rights ○ Packaging lifecycle

Within each of these three 'areas' we have a range of pre-defined 'issues' with which we tag each engagement. This includes around 30 material sustainability issues from the SRM framework, as well as five broad governance issues that we assess each company against (e.g. executive oversight and incentivisation; board oversight; transparency and related-party transactions).

This allows us to better track progress and share insights gleaned from individual engagements across the whole team – for example, we can look up how we have approached a similar issue in the past or within a different geography.

Setting Engagement Objectives

Ahead of each engagement we make, it is important that we establish objectives so as to be able to determine the subsequent effectiveness and thus refine our approach over time. Although these objectives can take numerous forms, we can categorise them into two main areas:

1) **Information exchange**

Given the dearth of disclosure in most emerging markets, this is a key tool for bridging the information gap that exists between the company and the public domain. Using this engagement form allows us to get a much better insight into what is going on 'under the hood' and peak into the future – for better and for worse. As such, we make a lot of information requests from our companies – examples including requesting details of the company's approach to employee rights, supply chain management or governance policy.

These exchanges are rarely unilateral demands, and we strive to share the learnings from our experience investing across emerging markets over many years back with our companies. This might take the shape of explaining what the leading players globally within a target company's sector are doing to address a certain issue; sharing the results of internal studies that we have conducted; passing on relevant third-party research; or introducing the company to solutions providers (e.g. marketing agencies, ERP solutions providers or sustainability reporting software providers).

These information exchanges originate from a variety of sources. Occasionally they are simply ad-hoc, but more often than not they arise from internal (e.g. a refresh of our due diligence reports on a company, the updating of our ESG assessments, or the writing of a thematic research piece such as our recent gender diversity study) or external (e.g. company disclosures or the publication of news) events. They can also take a variety of forms – calls, emails, meetings and letters.

In many cases, this exchange of information can provide us with enough comfort that a certain risk or opportunity is being suitably managed by the company. In these cases, we can conclude our engagement and report the learnings. In other cases, we may not be so successful, which forces us to either drop the issue, or to push for a behavioural change within the company.

2) **Behavioural change**

Following our research on a company, on or an information exchange engagement we will occasionally uncover concerns about how they are managing a certain aspect of their business. In such cases, we will engage with them in order to steer them towards better practices in the future – i.e. a change in behaviour.

This involves setting clear expectations with the management team, Board of Directors or promotors of a company about what we believe the company should be doing differently and why. Consequently, these engagements are almost always accompanied with a written piece (a letter or email) wherein we outline the justification for our request.

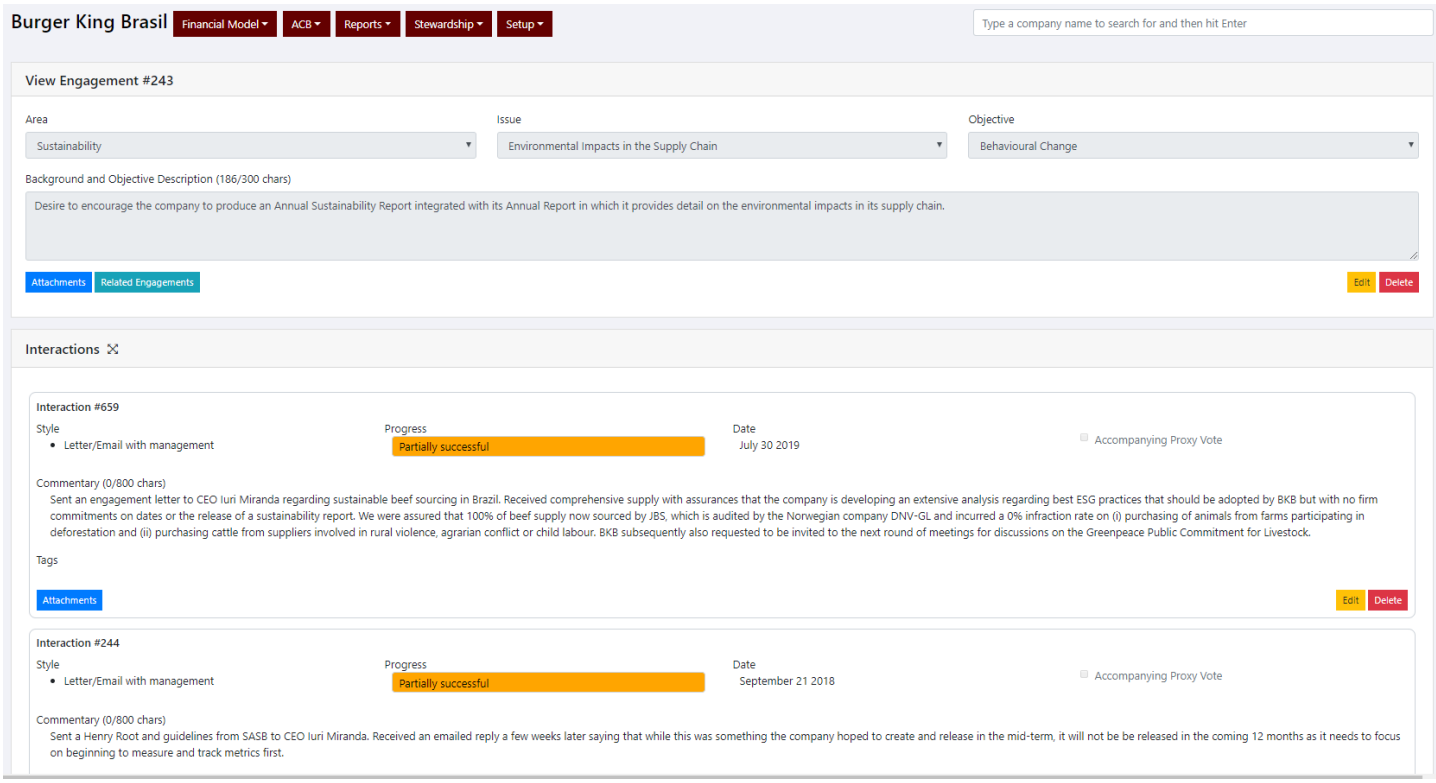
Progress here is typically much slower than for information exchanges, and given the greater demands upon a management team, the success rate is also lower. However, where we are successful here there is significantly more impact upon the business.

Tracking Engagements

Once an engagement issue and objective has been set for a given company, the covering analyst sets out their own approach on how best to interact with the company. Each subsequent 'interaction' (i.e. individual contact with the company on a certain issue) is then logged within the system, with the progress simultaneously measured versus the original objective (see snapshot below). This allows us to quickly review the history of our dialogue with a company on any specific issue.

The one caveat here worth mentioning is that we do not capture 'Information Exchanges' under 'Strategy' as these are routine during the meetings we hold with companies (and are captured within our company meeting notes).

Engagement Entry Page



Measuring the success of these engagements can be difficult and will always rely upon some level of subjective judgement by the investment team. Moreover, the progress of these engagements often needs to be considered over many years (for example gender diversity), making annual appraisals challenging. It is also important that we do not focus too heavily on this 'success rate' alone, as in many instances we can learn more from the honest 'failures'.

Engagement Summary Page – Company View

Godrej Consumer | Financial Model | ACB | Reports | Stewardship | Setup | Type a company name to search for and then hit Enter

Engagements | Add Engagement

ID	Area	Issue	Objective	Interactions	Progress	Priority*
361	Sustainability	Gender Diversity	Information Exchange	1		☑
357	Sustainability	Supply Chain Footprint	Information Exchange	1		☑
355	Strategy	Bonus issue to improve stock liquidity	Behavioural Change	1		☐
359	Sustainability	Waste Management	Information Exchange	0	-	☑
363	Sustainability	Supply Chain Footprint	Information Exchange	0	-	☐

*Try to choose up to 3 priority engagement issues, regardless of whether we have engaged with them or not

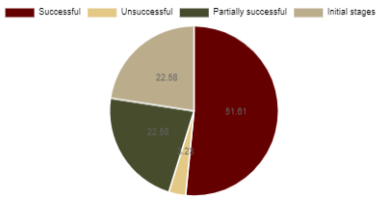
Legend: Progress

Initial stages	Unsuccessful	Partially successful	Successful
○	●	●	●

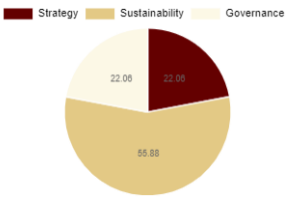
Engagement Summary Page – Portfolio View

Engagement Report - AACF | YTD

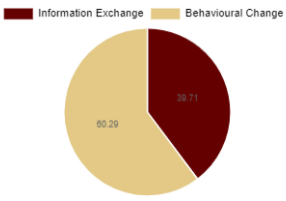
Engagement Status



Engagement Issue



Engagement Objective



Search:

Company	Last Interaction	Area	Issue	Objective	Interactions	Progress
Asian Paints	February 22, 2019	Governance	Board Oversight	Behavioural Change	1	○
Dabur	June 18, 2019	Sustainability	Gender Diversity	Behavioural Change	1	○
Dabur	June 18, 2019	Strategy	Strategy	Behavioural Change	1	○
Future Consumer Ltd	April 03, 2019	Governance	Shareholder Rights	Information Exchange	1	●
Godrej Consumer	September 18, 2018	Sustainability	Supply Chain Footprint	Information Exchange	1	●

4) Proxy Voting Tracker (still in design)

Shareholder votes have always been an important opportunity for us to table governance concerns we have with a company and in particular its Board Oversight. While analysts have diligently studied proxy materials and submitted their proposals, we have not had a centralised tool to track historic voting patterns, the rationales behind each decision and the supporting engagements we have had with companies. We believe that integrating this into a new Proxy Voting module will help us make more consistent and assertive voting decisions, while also incentivising analysts to engage with the Board and management around voting season: the period in which they are typically most responsive to governance suggestions.

Nature of Proxy Voting in Our Markets

Before diving into the module, it is worth putting the the companies and markets in which we invest into context.

Firstly, regulation around corporate governance is still in varying stages of development. In many markets, under-developed capital markets (i.e. characterised by a small or weak local institutional investor base) push shareholder rights to the bottom of the priority list for local authorities. Good examples of this include the Philippines, Nigeria or Egypt.

There is no great surprise in this – they have many more pressing issues to fight first - but it does mean that shareholders who invest in locally listed companies often have much less say in how a company behaves. For example, to make proposals for shareholder meetings often requires 5-10% equity ownership in a company. This often makes shareholder meeting agendas much more unidirectional than one might see in the US or Europe where stakeholders are able to put forward proposals.

Additionally, you tend to find tightly held companies (insiders own 49% of our companies on average across our emerging market Funds) with no requirement to form independent boards (see table below for context). Proxy votes can therefore often be nothing more than a formality. This makes engaging around these votes all the more important as it takes the message directly to the decision-makers.

Proxy Voting Backdrop Across a Selection of Arisaig Markets (June 2019)

Country of Listing	No. of Arisaig Holdings	Avg. Insider Shareholding of Arisaig Holdings	Shareholding Required to Place Items on Shareholder Meeting Agenda	Board Independence Requirement
India	12	54%	10%	33%
China	1	90%	3%	33%
Philippines	3	59%	N/A	2 Members
Vietnam	1	36%	10%	33%
Pakistan	3	69%	10%	1 Member*
Hong Kong	2	61%	5%	33%
Brazil	5	21%	1-5%**	20%
Mexico	5	57%	2 Shareholders	25%
South Africa	4	13%	2 Shareholders	50%
Turkey	1	54%	5%	33%
Nigeria	1	66%	5%	N/A
Egypt	2	46%	N/A	2 Members
USA	5	23%	1% or $2k	50%
UK	2	29%	5%	50%

**1/3 'preferred'*

***slides down with company size*

Source: OECD, Exchange websites, Arisaig Partners