ESG INTEGRATION
INSIGHTS

Q2 2017 ISSUE

I'm pleased to share with you the latest edition of *ESG Integration Insights*, featuring case studies from PIMCO and BlueSky Investment Management.*

When SASB launched ESG Integration Insights in December 2016, our aim was to highlight case studies written by investors, who shared insights into their use of SASB standards to inform investment decisions. Since then, we have published case studies quarterly from investors using SASB standards across a variety of asset classes (available in the SASB Library).

In this edition, BlueSky Investment Management's case is the newest addition to previously-published cases by UBS and Terra Alpha Investments discussing the use of SASB standards in equity analysis. PIMCO's case study offers insights to how SASB standards and their proprietary ESG scoring system inform credit analysis, adding to other fixed income case studies from Payden & Rygel and Breckinridge Capital Advisors, also in the SASB Library.

As ESG integration continues to evolve, we hope you enjoy these case studies and find them instructive. We also welcome case studies you may want to contribute to the growing body of work showing how SASB standards and tools are being used to inform investment decisions. Please contact me if you are interested in submitting a case for inclusion in future editions of SASB's *ESG Integration Insights*.

Best regards,

Janine Guillot
Director, Capital Markets Policy and Outreach

*These case studies refer to SASB provisional standards for which changes to certain disclosure topics and metrics are under consideration. Please refer to the Technical Agenda for a full list of proposed changes: https://www.sasb.org/wp-content/uploads/2017/07/SASB-2017-Technical-Agenda-072817.pdf

PIMCO – ESG for Commercial Banks

Think like a treasurer, engage like a partner, hold to account as a lender

PIMCO's sustainability/ESG framework

PIMCO has incorporated sustainability factors into its investment process for decades. The process emphasizes rigorous analysis of broad secular trends that are at the core of both global sustainability and long-term asset returns. In recent years, PIMCO has developed a platform that supports Environmental, Social and Governance (ESG)-focused investment solutions and has enhanced its credit research process to incorporate a robust ESG assessment for corporate and sovereign credit issuers that complements the traditional ratings assigned by credit analysts.

At PIMCO, we are in the business of delivering risk-adjusted returns for our clients in a manner that is sustainable over the long term. That means making sure that the investments we make on their behalf represent business models that are competitive not only today, but also well into the future. Our credit research analysts complement traditional analysis of companies' financial statements with careful consideration of intangibles and secular ESG trends that can have a profound impact on companies' financial condition if they materialize.

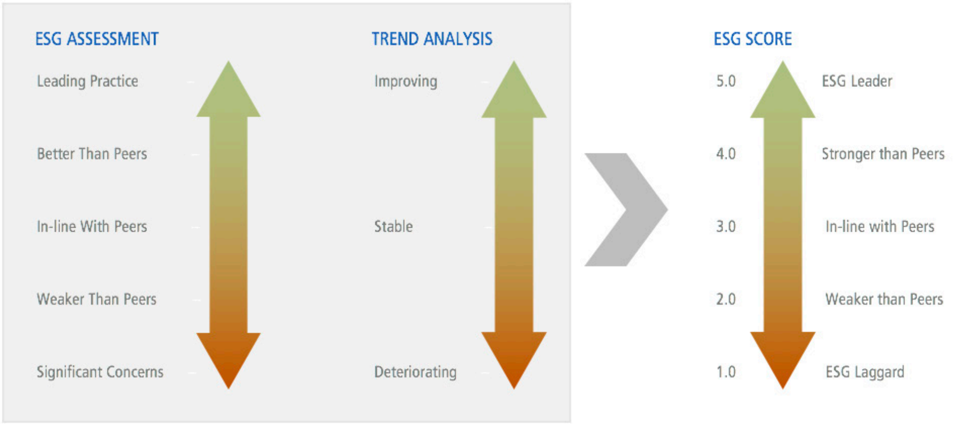
PIMCO is committed to being the world's premier fixed income investment manager. With our launch in 1971 in Newport Beach, California, PIMCO introduced investors to a total return approach to fixed income investing. In the 45+ years since, we have continued to bring innovation and expertise to our partnership with clients seeking the best investment solutions. Today we have offices across the globe and 2,100+ professionals united by a single goal: creating opportunities for investors in every environment.

Overview of PIMCO's ESG assessment

Overall process

PIMCO's 50+ credit research analysts assess the ESG profile of the issuers that they cover relative to peers with a goal of separating leaders from laggards. Using industry-specific ESG frameworks similar to the Sustainability Accounting Standards Board (SASB) materiality map, PIMCO analysts review their companies' ESG performance based on

Figure 1: PIMCO ESG Scoring System



information available in public filings, recent ESG news and controversies, as well as through regular engagement with company management teams to assign separate scores for Environment, Social and Governance. PIMCO's resulting ESG assessments are proprietary and distinct from those provided by ESG rating providers, with scores distinguishing between issuers with Leading Practice ESG practices to those that raise Significant Concerns (see Figure 1). Credit analysts also provide a forward-looking assessment of the ESG Trend for each issuer to recognize companies whose ESG performance is significantly improving or deteriorating. These factors are combined to create a granular PIMCO ESG Score that adjusts the relative weighting of the E, S and G pillar views and trend assessments based on the company's business profile and differences in industry dynamics.

Engagement with issuers

PIMCO believes that bondholder engagement is critical to understanding the risk and reward profile of the issuer and ultimately making investment decisions. Engagement can be a critical factor in encouraging positive change. The objective of engagement at PIMCO is to influence change, improve returns and reduce risks for our clients. Given PIMCO's size and global presence, our analysts and portfolio managers spend a significant amount of time meeting with senior management of issuers, including over 1,000 calls and in-person meetings conducted in Q1 2017 alone. In addition to discussing financial matters, we also focus on strategic issues that relate to responsible business practices, such as how risk management and business strategy address climate change risks. We also encourage firms to move toward greater transparency for reporting and disclosure among industries, including by encouraging companies to provide full disclosures using SASB standards. Information gleaned throughout the engagement process is incorporated into our ESG assessments, often pushing an issuer's ESG score higher or lower.

For ESG-focused portfolios, we follow a proprietary engagement protocol which is driven by a dedicated specialist working in concert with our broader ESG and portfolio teams. This protocol is guided by the following principles:

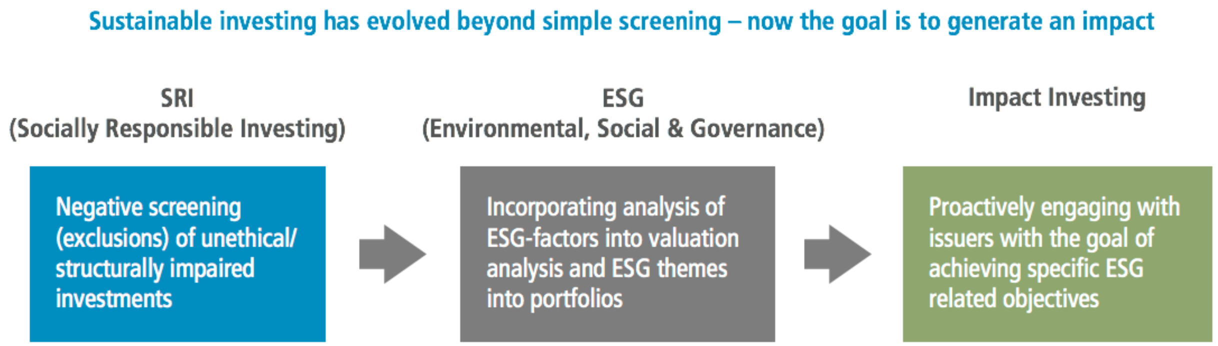
- Think like a treasurer: Identify issuers with capacity to change, then develop a set of core engagement objectives.
- Engage like a partner: Successful engagement is based on collaboration, a productive dialogue and mutual agreement on objectives.
- Hold to account as a lender: Measure progress against a pre-defined benchmark. Agree on planned remedies if underperformance is material. Divest where necessary.

PIMCO's engagement approach varies based on the specific engagement plan for each issuer and may include in-person meetings with company management, regular conference calls and questionnaires. Although we do not have access to the communication channels available to equity investors (e.g., proxy voting), given the scale of our fixed income operations and our touchpoints with company management we have found this method of dialogue to be highly effective. In addition, the fixed income universe offers the opportunity to engage with issuers who may not be accessible to equity investors, such as private companies and occasionally sovereigns.

Investing for impact

The engagement model is core to PIMCO's active management approach. We believe that an evolution is underway in which the passive screens traditionally used in Socially

Figure 2: Sustainable investing has evolved beyond simple screening – now the goal is to generate an impact

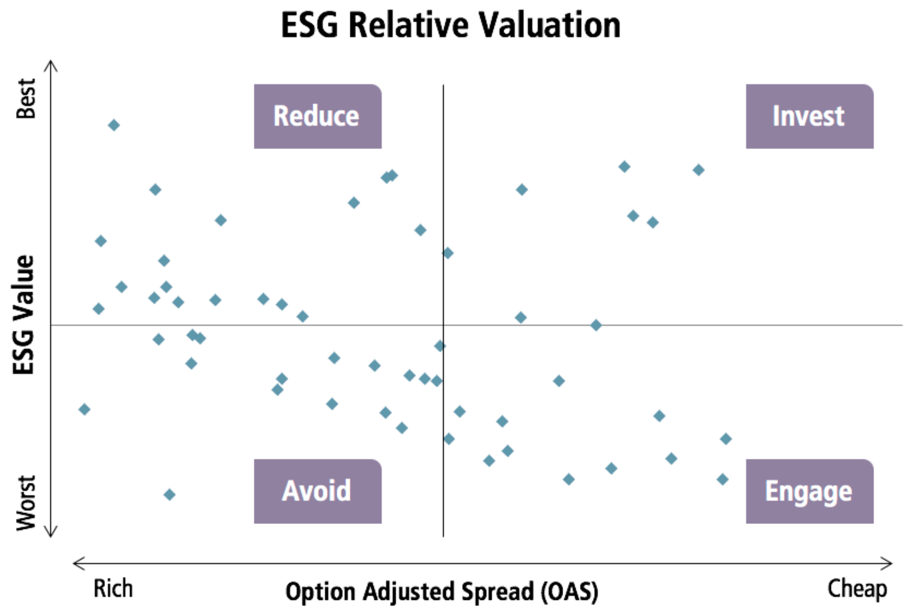


Responsible Investing (SRI) are no longer the only tools available for sustainability-minded investors. Dynamic analysis of material non-financial information in ESG investing enables PIMCO to evaluate corporate performance on ESG factors as part of our day-to-day credit analysis, and to incorporate ESG-related themes in our portfolios. The investment landscape is evolving even further via the ability to direct investments toward issuers through which measurable, beneficial social, or environmental impacts may be achieved – impact investing (see Figure 2). Our view is that credit investors can achieve an impact by proactively engaging with issuers to achieve specific, ESG-related objectives.

Integration into portfolio management

PIMCO credit analysts have assessed over 1,700 parent issuers on ESG performance to date. ESG assessments are highlighted in their credit research notes alongside our internal ratings and recommendations for portfolio managers to consider when they are evaluating investments for all PIMCO portfolios, including for non-ESG-dedicated accounts. Analysts' ESG views include narrative assessments and rationales for material factors that have the potential to impact investment performance. Over time, these assessments have been relevant in shaping the investments in our broader credit portfolios. For example, a generalist portfolio manager may decide to switch between two companies with similar fundamental risk profiles trading at comparable spread levels based on their relative ESG value. The illustration in Figure 3 below separates potential investments into four quadrants: Invest in issuers trading at attractive valuations and with strong ESG profiles; Engage with companies trading cheaply, but which have weaker ESG profiles; Reduce exposures to companies trading at unattractive valuations despite strong ESG profiles, and; Sell/Avoid companies with unattractive valuations and weak ESG profiles.

Figure 3: ESG relative valuation
Sample for illustrative purposes only



Case study of how PIMCO ESG research works in practice: ESG for commercial banks

The approach outlined above can be illustrated tangibly by focusing on how PIMCO looks at ESG for a specific industry: commercial banks. Analysis of ESG factors is particularly important for bank investments because the confidence of their depositors and borrowers significantly drives valuations. Public confidence in the banking system is crucial to the proper functioning of financial markets; likewise, the loss of public confidence in the banking system can severely damage overall economic growth.

The reputation of the banking industry has been tarnished in recent years by systematic failures of governance and breaches of public trust. However, we do not believe that these past transgressions should be overwhelming factors in the forward-looking ESG assessments of individual banks, particularly for banks that performed well through the crisis or banks that have wholly revamped their management teams and governance processes. We view the much stronger regulatory framework and elevated stature of risk management as significant credit positives, both in terms of the higher capital and liquidity balances now held by banks and in terms of lower earnings volatility. While many of the changes may have been mandated by regulators, leading banks have fully internalized the changes and have invested heavily in redefining their cultures and the conduct of their employees. As PIMCO considers investments in individual banks today, we seek to recognize banks that have made significant progress in improving their own cultures and conduct in addition to the more tangible improvements in risk management and financial product safety.

Material sustainability measures, including integration with SASB

PIMCO's ESG assessment for global banks incorporates many of the material sustainability topics and accounting metrics outlined in the provisional SASB Standards for Commercial Banks (see Figure 4). While our assessment of leadership and governance is paramount, we also carefully assess each bank's integration of ESG factors in its underwriting as well as the company's track record of regulatory compliance and litigation. Detailed stress test results provide a view of banks' internal risk management as well as the aggressiveness of company management in rewarding shareholders versus maintaining a conservative capital cushion in case of a downturn.

Figure 4: SASB Disclosure Topics for Commercial Banks

MATERIAL SUSTAINABILITY ISSUES

Social Capital
- Financial inclusion & Capacity Building
- Customer Privacy & Data Security

Business Model & Innovation
- Integration of Environmental, Social, and Governance Risk Factors in Credit Risk Analysis

Leadership & Governance
- Management of the Legal & Regulatory Environment
- Systemic Risk Management

Individual banks are assessed across 11 major factors ranging from Sustainable Lending Impact (which maps to 'Integration of Environmental, Social and Governance Risk Factors in Credit Risk Analysis' within SASB standards) to Systemic Importance/Regulatory Environment (maps to 'Management of the Legal & Regulatory Environment' in SASB standards) and Customer Privacy & Data Security. The individual scores then roll up to PIMCO's overall ESG Score, which places greater weight on Governance (60%) and Social factors (25%) and de-emphasizes Environmental factors (15%) given that the material non-financial risks facing bank investors have been historically related to Governance and Social exposures.

Comparing global banks across material sustainability factors

Figure 5 shows a high-level summary of how PIMCO's ESG scores for major global banks across geographies. While there remains considerable variation at the individual bank level within each region, this heat map provides portfolio managers with immediate insights into the key ESG strengths and weaknesses of major banking systems. For example, the U.S. Federal Reserve System has created a strong, stable regulatory framework, and its Comprehensive Capital Analysis and Review (CCAR) stress-testing process enforces strong risk management and capital discipline by constraining payouts to shareholders that could lead to undercapitalization in the event of a severe macroeconomic shock. This supports our stronger view of risk management and accounting at U.S. banks; however, banks in the U.S. have yet to demonstrate lasting improvements in culture/business conduct, and many continue to lag European peers at integrating ESG in underwriting and product safety.

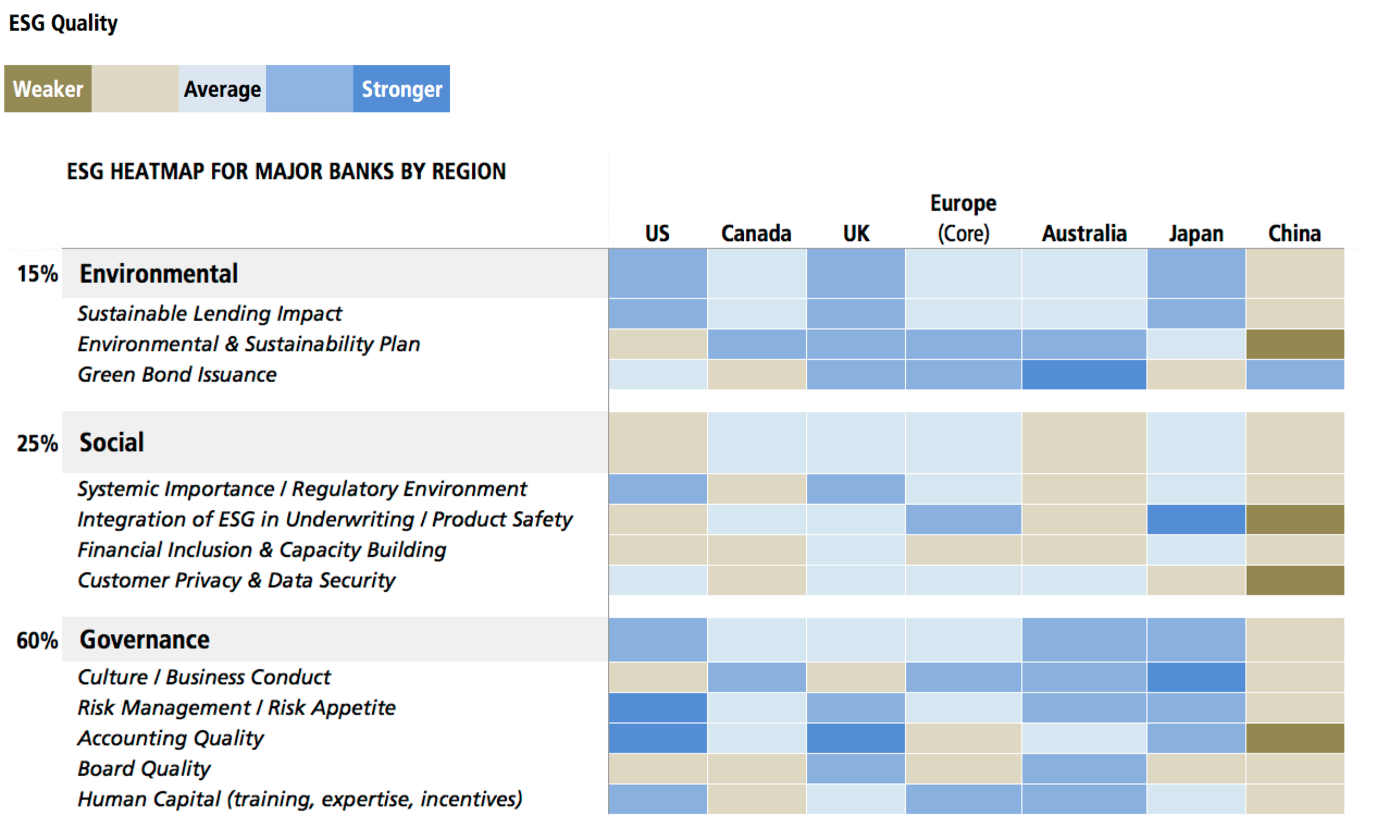
Overview of material ESG factors for global banks

Major factors that PIMCO tracks in ESG assessments are described below, many of which map directly to provisional SASB Standards for Commercial Banks. At present, few banks report according to the SASB Standards for Financial Inclusion & Capacity Building; however, we are encouraging banks to expand their disclosures.

Governance (60% of PIMCO ESG Score)

- Culture/business conduct represents a forward-looking view of the bank's internal business culture/ethical performance. Our assessment incorporates quantitative SASB measures such as the volume and severity of legal and regulatory settlements, though we recognize that these are often backward-looking metrics. Forward-looking inputs include our assessment of the company's reputation in the marketplace (e.g., do their bankers put client interests first?) and recent controversies (e.g., was senior management held accountable when customers were harmed?).
- Risk management represents our view of management's risk appetite as well as the company's capacity to manage those risks over the cycle. Our view incorporates the results of stress tests under adverse economic scenarios, one of the provisional SASB Standards for Commercial Banks. In addition, we consider how management balances short term ROE targets vs long-term solvency, how the company's loan portfolio and loss rates have performed over business cycles, M&A appetite and whether management has set and met achievable targets. We note that it is possible for leading banks to have an aggressive risk appetite as well as a strong risk management and culture.
- Accounting assesses whether the bank's disclosures are "credible," recognizing that accounting standards in some regions enable banks to delay recognition of bad debts for years or to systematically "optimize" risk-weighted assets to report higher capital ratios and/or enable higher payouts. We seek to avoid banks and banking systems that engage in such ploys, recognizing that many investors have been burned by simply trusting banks' published financial data. As a result, our assessments often vary as

Figure 5: ESG heat map for major banks by region



much by country as by company – e.g., peripheral European countries historically have had weaker accounting rankings than banks in the UK or U.S., where regulations are much more stringent and disclosures more robust and reliable.

- Board effectiveness represents our assessment of board leadership. Leading Practice banks have diverse boards with deep expertise in banking, risk & compliance and have a track record of replacing underperforming directors. Possible negatives include a combined CEO/Chair role, ongoing regulatory citations, and/or inconsistent strategic focus.
- Human capital is quite simply our assessment of the quality of the non-executive employee base. Does the company attract top candidates and provide them excellent training and advancement opportunities? We often do this using a simple thought experiment: Where would the bank rank for a top-tier graduate applying for a job, assuming that the candidate had received comparable offers from every bank? First-choice employers receive higher human capital scores; banks that attract employees with less sterling qualifications/reputations receive lower scores.

Social (25% of PIMCO ESG Score)

- Systemic importance includes elements of the Systemic Risk Management and Regulatory Environment disclosure topics in provisional SASB standards; however, PIMCO does not automatically presume that large, systemically important ("Too-Big-To-Fail") banks should be viewed negatively. In the post-crisis regulatory environment, the largest banks often offer the greatest protections to creditors due to tighter regulatory scrutiny and higher capital and liquidity standards. All else being equal, this means that bigger can be safer, even in the context of potential "bail-in" for creditors in a resolution. Systemic importance weighs on our ESG assessment only when the bank's business activities create negative social externalities, which we do not feel is still the case in the US and Europe.
- Financial inclusion/integration of ESG in underwriting assesses banks' commitment to providing financing to underserved market segments in a safe-and-sound manner (e.g., without exposing themselves to higher losses or potential regulatory fines). While prior infractions are considered, our rating is forward-looking and incorporates an assessment of both the scope of the lending commitment as well as the company's management of related risks. For banks with a focus on non-prime consumers, we look critically at the benefits that their products offer to customers rather than focusing only on the profitability to the bank. For example, a bank with a strong track record of providing home loans to immigrant communities at reasonable rates could score highly, while a bank offering high-fee, high-interest credit cards to low-FICO borrowers might score poorly. This strategy has allowed PIMCO to avoid payday credits that were later sanctioned by regulators or fined by the Consumer Financial Protection Bureau.
- Customer privacy & data security is at present a subjective measure given that few banks report the specific metrics recommended by the SASB (e.g., volume and impact of data security breaches). Until reporting becomes more ubiquitous, we reserve our highest scores for companies that have communicated strategic investments in data security and had no public data security breaches, while companies that have suffered such incidents score lower.

Environmental (15% of PIMCO ESG Score)

- Sustainable lending impact includes lending exposure to energy, oil & gas, basic materials and mining (SASB). PIMCO views "impact" here more broadly than simply the percentage of loans to industries with negative environmental impacts. We also look at underwriting trends, including whether the bank is reducing lending to the coal sector, expanding lending for renewables and whether the bank is involved in controversial projects.
- Environmental impact & sustainability plan includes a discussion of credit risk to the loan portfolio from climate change (SASB). Leading Practice banks have disclosed detailed sustainability targets and made public greenhouse gas reduction commitments. Extra credit is given for banks that have explicitly mapped their revenues to Sustainable Development Goals (SDGs).
- Green bond issuance gives credit to banks that have been active in issuing "green bonds" – instruments that fund projects with positive environmental benefits – either as a part of their own funding or on behalf of clients.

Conclusion

PIMCO incorporates ESG analysis throughout its investment process to ensure that all portfolios benefit from a detailed review of significant non-financial factors that have the potential to impact long-term credit performance. This analysis supports our favorable credit view for leading global commercial banks given the significant regulatory and risk management improvements that have been made since the crisis. Looking ahead, we will continue to engage with major banks to encourage ongoing improvements in their sustainability and social lending programs, and we will continue to encourage banks to improve the quality of their sustainability disclosures, in particular by disclosing the provisional SASB standards.

BlueSky Investment Management

ESG Integration: the Evolution of Value Investing

Introduction

Professional investment management is organized around the principle of fiduciary duty. Simply stated, a manager's actions must be undertaken for the sole benefit of the client, typically measured by risk-adjusted financial return. Today, there is mounting evidence that environmental, social and governance (ESG) factors can impact financial return, including a wide body of academic studies, investment bank research, as well as research conducted by the Sustainability Accounting Standards Board (SASB). To further explore the impact of ESG on financial return, BlueSky conducted our own research over an 18-month period and found that, while the majority of ESG data available showed little value, there is a high correlation between material ESG factors and share performance and return on invested capital (ROIC), confirming the significant financial impact of ESG and consideration of these factors in the investment process.

We believe the performance of many recently created ESG-focused products suffers from the following shortcomings:

- Use of ESG as a secondary screening tool, and reliance on subjective third-party ESG scoring and rating methodologies that may have little or no connection to financial materiality
- Strong home country bias among US investment managers, offering few global or international equity ESG-integrated investment solutions
- Integration of ESG in investment decisions solely from a growth investing perspective

The financial materiality of ESG factors can influence both value and growth, and can be applied beyond the US to evaluate international companies.

BlueSky is a global fundamental value investment management firm, dedicated to active, high quality value equity investing and founded on a process-driven, repeatable approach. We seek high-quality businesses, with enduring competitive advantages, purchased at reasonable prices. Our unique investment approach integrates material environmental, social and governance (ESG) factors that our proprietary process has demonstrated to be highly correlated with performance. We believe our broader perspective to investing, which analyzes companies across a wider set of material information, can enhance performance and provide superior risk management.

ESG Integration: the Evolution of Value Investing

BlueSky was founded on the simple concept that integrating value investing with ESG analysis can enhance performance and better manage risk – that ESG integration is an evolution of value investing. In short, this approach employs a wider lens that can more fully reveal risks and opportunities leading to better investment outcomes. BlueSky is unique as an ESG integrated fundamental value firm with global, international, and US strategies. As value investors, we believe the key to long-term investment success is our ability to identify and purchase companies that trade at significant discounts to their intrinsic value and sell these investments when intrinsic value is realized. From our perspective, integration of carefully selected and financially material ESG factors represents a significant opportunity to evolve and improve upon traditional value investing techniques. Our ESG integration approach broadens the pool of potential risks we seek to avoid while also identifying potential competitive advantages, enabling the evaluation of companies across a more complete set of material information to drive better investment decisions.

Margin of safety is one of the key principles of value investing, originally developed by Benjamin Graham and described in his book, *The Intelligent Investor*. This simple concept is the cornerstone of active investment management, which illustrates the importance of buying a company at a significant discount to its intrinsic value. The greater this discount, the greater the margin of safety. Stocks trading below their intrinsic value will typically fall less in a declining market and thus offer the benefit of lowering investment risk. We believe ESG integration further enhances value investing principles; managing material ESG risks can reinforce the margin of safety principal.

In determining a company's intrinsic value, fundamental value investors have traditionally focused on ROIC, free cash flow, strength of balance sheet, margins, competitive advantages/moats, and management team quality. Including analysis of material ESG issues that may affect a company's intrinsic value can strengthen the fundamental value investing framework.

One might ask, how can a company's ESG performance be tied to financial performance and affect the fundamental value analysis? While material ESG factors differ by sector, we offer some broad examples of how a company's ESG performance can create shareholder value or affect company risk in Figure 1, below.

Figure 1: Value Creation and Risk Management in ESG Factors

Value Creation	**Environment** Companies increase profitability through effective resource management, waste reduction and adoption of sustainable processes.	**Social Capital** A high quality workplace can be key in attracting and retaining top talent, which can increase productivity, reduce employee turnover, and create significant competitive advantages.	**Leadership and Governance** Sound governance practices create a culture of transparency and accountability, safeguarding license to operate and reinforcing brand reputation. Prudent management of the supply chain can help protect fair treatment of the workforce and suppliers and help ensure ethical sourcing of materials. Strong brand reputation can boost demand for products or services.
Risk	Poor environmental performance can increase cost of capital, operating costs, and create potential liabilities including fines and lawsuits.	Poor management of human capital can create higher turnover, increase costs, and make companies less competitive.	Poor governance can result in fines, legal costs, disruptions to materials, labor and productivity, negatively impact revenues, increase cost of capital, and severely damage brand reputation.

Figure 1 clearly demonstrates the potential financial impact of ESG. BlueSky believes that it is our fiduciary duty to integrate ESG across material issues that can impact a company's financial performance. From our perspective, it is only a matter of time before investors recognize that the real risk lies in the failure to assess ESG impacts in the investment process.

Nonetheless, we have found it challenging to find quality ESG data to properly evaluate how companies are responding to material ESG issues. Despite a growing body of ESG data in the marketplace, investors are faced with the following problems:

- Data of varying quality
- Understanding what is being measured
- Subjective ratings and ranking methodologies
- Immateriality of data disclosed
- Limited coverage beyond large caps

Development of BlueSky Investments' ESG Integration Methodology

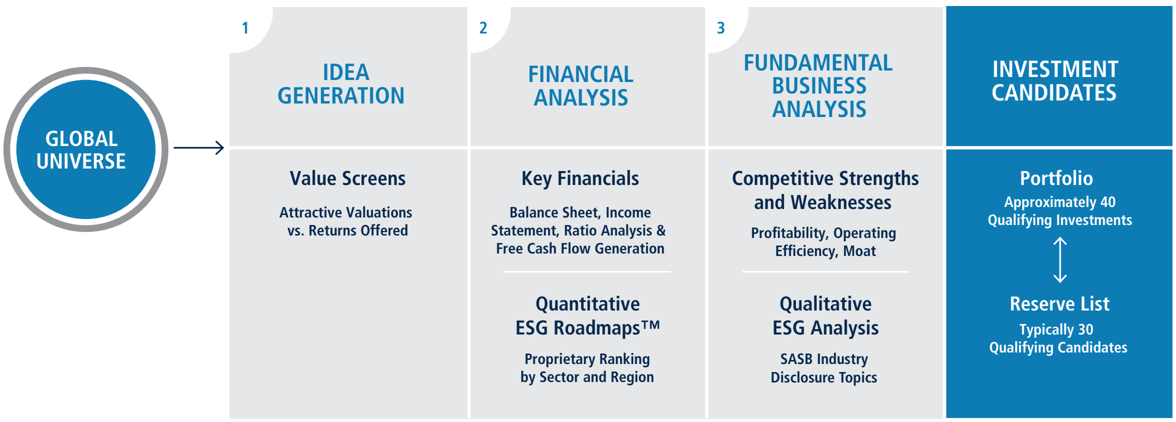
Faced with the aforementioned ESG data challenges, BlueSky conducted 18 months of quantitative research to explore the financial materiality of ESG issues, with the goal of integrating material ESG factors into a fundamental value investing framework.

Our research determined that the materiality of ESG factors varied by sector and region. Companies performing well on material ESG factors in a given sector and region were positively correlated to both increased ROIC and share performance. The major stumbling block revealed by our research was that much of the current body of ESG data provides little correlation to performance and risk, emphasizing the importance of an empirical approach.

BlueSky proceeded to develop a proprietary ESG evaluation framework designed to drive alpha and better manage risk. We created over 40 unique ESG Roadmaps™ comprised of material ESG factors unique to each sector and region. We then ranked companies based on a composite score of empirically selected material factors sourced from corporate disclosures, specialized datasets, and other publicly filed information. This process allowed us to integrate only financially material ESG data that adds value to our process, while ignoring vast amounts of data that was financially immaterial.

During the initial phase of our investment process, companies identified by our value screens are then evaluated through our proprietary quantitative ESG framework, which ranks each company's ESG performance on financially material issues by sector. Utilizing these screened results, the firm concentrates on the most attractive three deciles (30%) of companies for portfolio inclusion. We then screen for quality to further narrow portfolio candidates, considering, among other factors, balance sheet strength, operating efficiency and profitability.

Figure 2: BlueSky's investment process seeks to broaden traditional fundamental value work by integrating the quantitative and qualitative ESG assessment described below.



To provide a more complete understanding of a company's ESG performance on material issues, BlueSky combines our quantitative work with an equally focused and rigorous qualitative ESG analysis. This is particularly valuable in situations where there is limited ESG data. SASB industry standards and disclosure topics are integral to this phase of analysis, providing ideal roadmaps to best assess each company's unique subsector risk exposures and potential opportunities.

In this final phase of evaluation, we closely examine a company's management quality, its three to five year business outlook, and its ability to maintain competitive advantages. Fundamental analysis of a company's operational performance and survivorship is based on profitability, leverage, and liquidity rates. Companies that do not score above-average on our ESG ranking or that lack sufficient ESG data may be further considered if there is reasonable confidence the company is performing well across SASB industry disclosure topics in our qualitative assessment. ESG risks and opportunities unique to each company and sector are discussed and carefully considered in determining future outlook. (See Figure 2.)

Case Study: Howdens Joinery

Howdens Joinery Group Plc is one of the largest integrated suppliers of kitchens and joinery products in the United Kingdom. Founded in Yorkshire in 1995 under the name Galiform Plc, the company originally operated as a successful business unit within MFI Industries. Following a restructuring, MFI sold its unprofitable retail businesses to focus on the more profitable Galiform, and the company was renamed Howdens Joinery in 2010. Last year, Howdens designed, manufactured and sold over 400,000 kitchens, 2.5 million doors, and 770,000 appliances in the United Kingdom alone. This was accomplished through their network of over 600 outlets across the UK that cater primarily to local tradesmen. With presence in Belgium, France, Germany, and the Netherlands, Howdens is testing formats for potential expansion.

In the fall of 2016, Howdens first appeared on several of our value screens after falling approximately 25% following the UK vote to leave the European Union. We believed the market fears were at extremes for a company that had sound management, competitive gross and operating profit margins, good cost controls, and a flexible business model with sound incentives for both managers and employees of outlets. Additionally, the company was buying back shares and had net cash on their balance sheet. Howdens had also demonstrated it had pricing power and was able to navigate successfully through the 2008 credit crisis.

From an ESG perspective, there was limited coverage of Howdens across the material ESG data in our proprietary quantitative model. Had our approach relied solely on ESG data, we would not have been able to continue with our analysis. However, because our process utilizes both data and a qualitative ESG assessment, we were able to move forward with our research. We began analyzing the company's performance across material topics identified in SASB's SICS classification for Building Products & Furnishings (Consumer Goods Sector*). Here are our findings:

SASB Disclosure Topic: Energy management in manufacturing

Howdens Joinery has been certified by the Carbon Trust Standard for several years in recognition of their success in reducing overall energy usage and their commitment to continued reductions. The company reduced its carbon footprint (tCO_2e per £m) by 13.4% from 2014 to 2016. Over this time period, the company's total scope 1 and scope 2 emissions have remained relatively flat while revenues increased by 19.8%. The company has reduced energy use through technology innovations in their cabinet production, conversion to LED lighting, and other efficiencies. Additionally, the company manages and measures truck fleet efficiency, having improved miles per gallon by 7% since 2014.

* In 2018, SASB's Sustainable Industry Classification System (SICS) will be updated, at which time the "Consumption II" sector will be renamed "Consumer Goods."

Case Study: Howdens Joinery (cont.)

SASB Disclosure Topic: Management of chemicals in products

The company follows a number of regulatory guidelines and processes to ensure safety of workers and consumers of its products. Howdens' internal process is governed by the Control of Substances Hazardous to Health (COSHH) Regulations 2002. Under these guidelines, the company is required to formally assess and approve chemicals used in manufacturing, maintenance, and cleaning. This includes the impact of chemicals on workers in the manufacturing process and the full life cycle impact. The company also requests formal confirmation from all suppliers that there are no Substances of Very High Concern (SCHC's) as listed under the Registration, Evaluation, Authorization and Restriction of Chemicals (REACH) Regulations. Howdens' cabinets are manufactured from pre-made wood based panels that are certified under the EU Construction Products Regulation, which conforms to strict chemical standards. The company also performs risk assessments of materials and products in terms of country of origin, degree of complexity, and prevalence of non-compliance based on industry intelligence. Higher risk products are then screened through additional testing to ensure compliance with required standards.

SASB Disclosure Topic: Product lifecycle environmental impacts

The company has been successful in reducing waste in its manufacturing process through the implementation of newer machinery and the use of software technology. They have worked with suppliers to manufacture custom-sized chipboard in order to ensure minimal waste in production. Despite this, since wood-based products make up over 75% of their products, the company produces a lot of sawdust waste. The company realized an opportunity to use the sawdust waste as an energy source and installed efficient biomass boilers at their two manufacturing sites in 2015. Over 12,000 tons of sawdust was converted to energy in 2016, generating approximately 42,000 MWh of energy. The company recycled or reused 98% of its total waste in 2016. 100% of all packaging was from recycled sources. The company implemented a policy of repairing and reusing wooden shipping pallets over nine years ago. In 2016, over 165,000 pallets were repaired and reused, thus significantly reducing what might have become addition waste.

SASB Disclosure Topic: Wood sourcing

Over 75% of Howdens' products are wood or wood-based and the company sources 100% of wood-based materials from FSC (Forest Stewardship Council) certified sources. FSC is a non-profit organization setting what are widely considered to be the gold standard for responsible forest management and wood sourcing. The company is committed to using FSC certified sources to ensure that there is independent verification of responsible sourcing. The company also works closely with suppliers to ensure continued compliance with FSC standards.

With very little ESG data to rely on, this qualitative ESG assessment gave our team a high degree of confidence that Howdens Joinery was performing well across financially material ESG factors. This example highlights the challenges regarding the state of ESG data, but also emphasizes the importance of combining both data and qualitative ESG research. SASB's research helped us focus on material topics likely to impact financial performance and, following further fundamental work, we ultimately added Howdens Joinery to our portfolio. Had our process relied solely on ESG data, we likely would not have been able to move forward with purchasing this company.

ESG in the Global Context

As part of our proprietary research, BlueSky examined ESG materiality globally and we found much of SASB's industry standards to be applicable in analyzing European companies. However, within a global context, BlueSky has observed regional and cultural differences that required us to create customized ESG Roadmaps™ that incorporate only those ESG factors that are uniquely correlated to financial performance in that particular region. For example, we have found very little materiality across social factors in Japan, while certain environmental and governance factors remain important there. Our quantitative research found social factors such as supply chain management, workplace satisfaction, human capital development, and employee retention to have no correlation to increased ROIC or share performance, while these same factors showed more significant correlations to increased ROIC in both the US and Europe. Further, to compare a Japanese industrial company to a European industrial company requires a more nuanced approach due to, among other things, the keiretsu corporate structure prevalent in and unique to Japan. At BlueSky, we made the strategic decision to carve out Japan and other geographic regions as separate universes in order to effectively evaluate and rank companies on financially material ESG factors.

In Conclusion

While we believe it is challenging to formally quantify all ESG risks and opportunities, our quantitative work combined with our qualitative ESG analysis (which leverages SASB's framework) allows our team to confidently assess a company's performance across financially material ESG factors. Our team can then discuss each individual portfolio candidate within our holistic value/ESG framework. ESG provides an important measure of corporate quality that broadens traditional fundamental value investing to more fully reveal risks, opportunities, and competitive positioning. Through this wider lens, we are able to identify great businesses at attractive valuations where we are confident that the company is addressing material ESG risks that reinforce our margin of safety. Our focus on financially material ESG issues also assists us in identifying companies that may have competitive advantages that can increase intrinsic value.

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