ESG Now Podcast
“The Luxury of Love”

Transcript, 16 February, 2024

Mike Disabato (00:00):
What's up everyone? And welcome to the weekly edition of ESG Now, where we cover how the environment, our society and corporate governance effects and are affected by our economy. I'm your host Mike Disabato, and this week in honor of Valentine's Day, we are discussing the ESG of the luxury industry. Thanks as always for joining us. Stay tuned.
(00:29):
It was just Valentine's Day and I'm sure all of you out there got yourself something nice and luxe. Since the world is a sad hellscape that can only be subdued by the simple pleasure of material possession ever fleeting, it may be, but you don't want to add to that hellscape. So as a savvy consumer, you want to figure out where your products came from and how they were made to ensure you haven't impacted the environment or you tacitly accepted coercive labor practices in your rush to engage in cathartic retail release. But how possible is it for you to do that? To answer that question today, I wanted to focus on luxury goods because everyone knows you can only show your partner or yourself that you love them if you buy them luxury goods. No other gift works folks. It hurts me to say it. So I called up my colleague Liz Houston, who covers what is called the textiles, apparels and Luxury Good sector. And we got into a conversation about transparency in the luxury industry from the consumer angle and from the investor angle. And we did that because I believe all of you heroic listeners are my Valentines, and I wanted to arm you with the knowledge needed to buy me sustainable luxury goods. So first I asked Liz to give me the background of production in the luxury industry.

Liz Houston (01:45):
If I look at say the last 10 years or so of accusations against companies in this industry in terms of the negative impact that they may be having on the world, it kind of falls into three broad buckets. So the first would be animal welfare concerns, and then the second is the social impact of supply chains. So the workers being paid adequately, are the factories safe, are there any forced labor allegations? And then the third is environmental. So particularly in the realm of soft luxury, by which I mean clothes and handbags and shoes and things, and literally things that are soft. The environmental impacts are things like leather and deforestation or the environmental impact of textile production on the climate and specifically separately harm associated with visco or other manmade cellulosic, which might be things like rayon or mod, which have lots of attractive properties, but use a lot of very dangerous chemicals in their production.
(02:58):
Hard luxury is slightly different. So hard luxury, by which I mean watches and jewelry and the shiny literally hard things. It's similar to soft luxury in that we're talking about sourcing and supply chains as the source of most of the potential or actual negative impacts. But we need to think about different kinds of supply chains. So gold, diamond and gemstones and the risks in there are slightly different. So you could be thinking about the environmental impact of mining or working conditions in the supply chain, things like child labor in artisanal or small mines. And then you have a new potential negative impact, which is around funding conflict. So most of us may have heard of the concept of blood diamonds, and gold is certainly one of the minerals that most regulators look at for potential involved in funding conflict worldwide.

Mike Disabato (04:00):
In some what Liz is saying, there is nothing new but something to remember with luxury. It's all about the supply chain. Take the rayon and modal that Liz mentioned when talking about soft luxury. For all that you

don't know, those are fabrics. They're the sort of fabrics that are said to drape nicely and wear well and are used for their luxurious appearance. And things like lacy lingerie, the sort one might gift their partner on Valentine's Day. But there can be problems with these fabrics if they're not made with proper oversight. Modal fabric is made using a chemical treatment process that can be harmful to the environment if not properly managed. And rayon is a semisynthetic fabric derived from cellulose, a natural component found in wood pulp, and that is plagued by the same chemical treatment that modal fabric is that can be harmful to the environment if it's not properly overseen and it would pulp if not sourced from sustainable areas can be linked to deforestation. So the question then is how well are these production processes being overseen? If the Gucci loafers are buying or upwards of a grand, you'd think the company would know where the supply of its leather is coming from, right? I asked Liz.

Liz Houston (05:13):
Consumer goods supply chains are really hard to trace, and the first step for a lot of companies when they're trying to figure out where their risks are or their potential impacts is to map those supply chains. And that is hard, but in theory, luxury is quite well-placed to deal with this, particularly at the very high end because of the nature of the business, they're probably working with a relatively small number of suppliers that they've got long-term relationships with because things like quality are very, very important in high-end luxury. It doesn't mean everyone's doing it, but it's possible what I would call or what other people have called masstige or accessible luxury is slightly harder. And that's where, particularly in clothing, you might have something that's a luxury brand but has a model that's slightly more similar to a mass market brand with lots and lots of different suppliers, lots of different layers in the supply chain.
(06:19):
So with that backdrop, what do we look at when we are looking at company's approach to this? We look at what they're saying about due diligence in their supply chains, what support they give suppliers and what commitments they've made. So for example, Burberry, the British luxury brand, they have made a public commitment to the adoption of living weight in their supply chain. When it comes to things like raw materials, we look at what companies say about the traceability of their raw materials. So do they know what farm the leather came from and what are they doing to make sure it's not associated with deforestation, that sort of thing. And then for impact on climate change, we look at the product carbon footprint. So does the company know what the greenhouse gas emissions are coming from production and what is it doing to reduce them?

Mike Disabato (07:10):
All of this requires some sort of supply chain due diligence for these companies. The organization for the Economic Cooperation and Development, OECD lays out in depth what companies need to do to make this due diligence a reality. The OECD asks them to have a systematic approach to risk assessment that is outward looking, meaning assessing the risks that the company does to the world, not just to their business. It wants companies to follow up on any policies that they put in place with suppliers. Sometimes that involves audits, but audits are just one part of the system and it sometimes it's just helping suppliers to behave responsibly and training supply chain workers and all that. There's also some tech-oriented attempts in the industry to map its supply chain. One of those is called the Aura Blockchain Consortium, which is a platform where each party in the supply chain is involved in validating ledger transactions, which are then added to the blockchain as a permanent tamper proof chronology of orders, shipments, invoices, and payments. And now I should note that the Aura blockchain method is being used mainly for authentication. There are a lot of luxury counterfeit products out there, but it can also be used to verify every step of the supply chain for a high end product, which is useful for companies if regulations start to push them to have a better and more transparent supply chain for its consumers.

Liz Houston (08:39):
The regulatory landscape is in a little bit of flux at the moment. There are some really big pieces of legislation potentially coming, which would be a step change in terms of what's expected of companies. One is the eus

corporate sustainability Due diligence directive, which you've talked about before. And I have to caveat that by saying this is the 15th of February, and as of right now it hasn't been finalized. That could change. Also proposed is the Fashion Act in New York, which again would increase the due diligence requirements of companies and what's required of them in the effort to address climate change. But even without these two, the direction of travel is towards more regulatory focus of the impact on supply chains.

Mike Disabato (09:29):
Some raw materials remain hard to trace. Leather for example, is a notoriously difficult product to understand where it comes from due to the various issues with the livestock trade that I don't really want to go into because it would take us down a completely different episode. But other more luxurious raw materials than animal flesh are more easily traced and thus more readily regulated.

Liz Houston (09:51):
In general. There's already quite a lot more regulation around gold as a conflict mineral, which means companies have to be on top of their due diligence requirements. So that's particularly in the us, EU and Switzerland. Switzerland introduced recently new laws around due diligence requirements for conflict minerals and child labor, which is very relevant for the hard luxury space because there are some pretty important Swiss companies in this sector. Fun fact about gold though, which is that there's way more above ground than there is below, and it's endlessly recyclable does not tarnish. This is one of the reasons that humans love it. So this is a material that you should not have to use any virgin stocks in your production.

Mike Disabato (10:43):
And of course, recycled products are cheaper than virgin stocks to use in a production process. So when possible companies use the recycled over the new take Richemont, which I'm sure I pronounced just terribly, but Richmont owns Cartier and they have a commitment to only source recycled gold for their products. Now take diamonds though. Diamonds still remain harder to deal with, but they at least have a lab grown supplement. And Liz told me, when it comes to color gemstones, all bets are off. They come from small minds globally, and all the companies she speaks to in the luxury industry say it's incredibly difficult to have any transparency in your colored gem supply chain. Meaning if this Valentine's Day you bought anything other than gold, you're a destructive person who no longer has morals and should never find love. But what if you are the sort of romantic that doesn't want material goods, those fickle things.
(11:41):
Instead, you want to give your Valentine a stock portfolio full of luxury companies that they so desire which they can then own as a shareholder. You gift your Valentine a portfolio of love, I'll just call it for some reason. And once you're gifted this portfolio of love, you care about the environmental and the social side of these companies. Yes, but now you also care about how the companies run. You care about the governance of these luxury companies. So we can shift toward the discussion about how these executives of these luxury brands are putting together their oversight committees and everything that goes into governance of a company. So I asked Liz to tell me about the governance structures of these luxury companies in the industry.

Liz Houston (12:25):
A quite prominent feature of the luxury space is that it is made up of an awful lot of family firms. So there are lots of reasons that investors like family firms. I am told that it can mean that management has a longer kind of outlook, longer time horizon when they're thinking about investing, which a lot of investors like. However, where the family firm might also have controlling stake. Again, not necessarily bad in itself, but where you do have a controlling shareholder, it's often important for minority shareholders to look out for other risks that maybe their rights are not fully being taken care of. When we look at the luxury space, there are a number of these controlled family firms that we would flag for concerns around excessive influence from leadership, for example, or where the company is being controlled by stock pyramids, where it's not always obvious who's controlling what. The other thing that investors might want to look out for is what succession planning is in

place. So where you have perhaps a family firm that has a controlling shareholder and that controlling shareholder is running the business, that's quite a lot of key person risk right there. And nobody runs a business forever. So minority shareholders need to make sure that they are happy with whoever the replacement might

Mike Disabato (14:08):
Be. I'm glad we ended there on happiness because like retail therapy, like luxury, happiness can be fleeting, but what isn't fleeting is the knowledge that you all now have on the luxury industry, the attempts at transparency, the limitations they're in, and the type of organizational structure you may or may not want to invest in. And that's it for the week. I wanted to thank Liz for talking to me about the news with an ESG twist. I wanted to thank you so much for listening. If you like what you heard, don't forget to rate and review us. That always helps us get higher on podcast lists and more people can find us. And if you'd like to hear myself or any of the other co-hosts of ESG now, please subscribe wherever you get your podcast. Thanks again and talk to you soon.

Speaker 3 (15:02):
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