Environmental, Social & Governance Report

2st Quarter 2017

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Introduction

Our current Environmental, Social and Governance (ESG) quarterly report (2nd Quarter 2017) focuses on the retail sector, specifically The Foschini Group Limited (TFG). The sustainability of global supply chain has been a key focal point for activist organisations putting companies under pressure to not only focus on creating value for shareholders but for all stakeholders, and thus “Creating Shared Value.”[1] Consequently, the retail sector has been challenged to respond to issues around business ethics, human rights violations, worker health and safety, fair wages as well as resource and environmental management in their supply chain.[2] Given the backdrop of these challenges and because sustainability, with respect to ESG issues, is becoming a mainstream investment criterion, companies’ response to such issues has been a key differentiator of management’s maturity. TFG management has been more proactive compared to South African peers in responding to ESG principles.

Investment case

TFG is both diversified on a product offering as well as geographically with operations in Africa, UK, Europe and Australia. The group has also mitigated its exposure to credit sales and delivered strong cash sales growth. Below we highlight some of the key investment considerations.

We are constructive on the TFG investment case due to the following factors:

- Diversified product offering across womenswear, menswear, homeware, jewellery and sportswear
- Targets consumers across the income spectrum (low to high LSM)
- Geographic diversification - Africa, UK, Europe and Australia
- Balanced cash to credit sales mix
- Rand hedge – c25% of the earnings before interest and taxes (EBIT) the 2018 financial year end is in hard currency
- Valuation - TFG trades on a 2018 calendar year P/E of 10.9x and offers 3 year earnings per share capital adequacy ratio of 8.1% on our estimates and a Dividend Yield of c6%. This offers 25% total return to our R166 target price on an exit multiple of 13.5x.

Retail sustainability challenges

The wave of fast, trendy and affordable fashion has helped improve lives through job creation and giving people access to affordable quality clothing across LSMs. However, that trend has been met with critiques such as the “perpetuation of a clothing wasteful culture.” The incident in Bangladesh at the Rana Plaza in 2013[3] brought to the fore the need for scrutiny of big global retailers, especially their supply chain and in particular around issues of ethics, human rights, worker health and safety, fair wages as well as resource and environmental management. Initiatives like the Sustainable Apparel Coalition’s (SAC) Higg Index, third-party certification (GoodWeave and Fair

[1] *Creating Shared Value*, Harvard Business Review, by Michael E. Porter and Mark R Kramer
[2] TFG 2015 Sustainability Report
[3] https://en.wikipedia.org/wiki/2013_Savar_building_collapse

Trade) and the Organic Cotton Accelerator are steps in the right direction in terms of enforcing some level of compliance to ESG issues by companies.[4]

Another critical challenge that has faced the retail sector recently has been a shift from a “linear business model” to a “circular business model.” A circular business model not only focuses on getting products to consumers but also on ways to recycle the products after use. Thus the retail “linear business model” has come under pressure and that has resulted in big global retailers such as Patagonia, H&M and M&S trying to close their business loop through clothing exchanges and repair initiatives in their stores.[4] To this end, H&M incentivises customers to participate by issuing coupons and discounts for returned merchandise.[4,5]

Though small in the global context, SA retail companies are not entirely shielded from the abovementioned challenges facing the sector. Over and above these global challenges SA has its own unique challenges such as employment equity, local sourcing of merchandise (supply chain), training & employment, affordability of clothing, credit sales and so on. TFG’s response to both the global and local challenges shows superior management maturity. Some of TFG’s highlights include The Feel Good Project, where TFG donates/sells (at competitive prices) returned or reject merchandise to The Feel Good Project for repair and reselling. The project provides unemployed youth with training, entrepreneurship, job creation and income opportunities in retail, garment repair and warehousing.[6] The Feel Good Stores are located in Khayelitsha and Claremont, Cape Town.

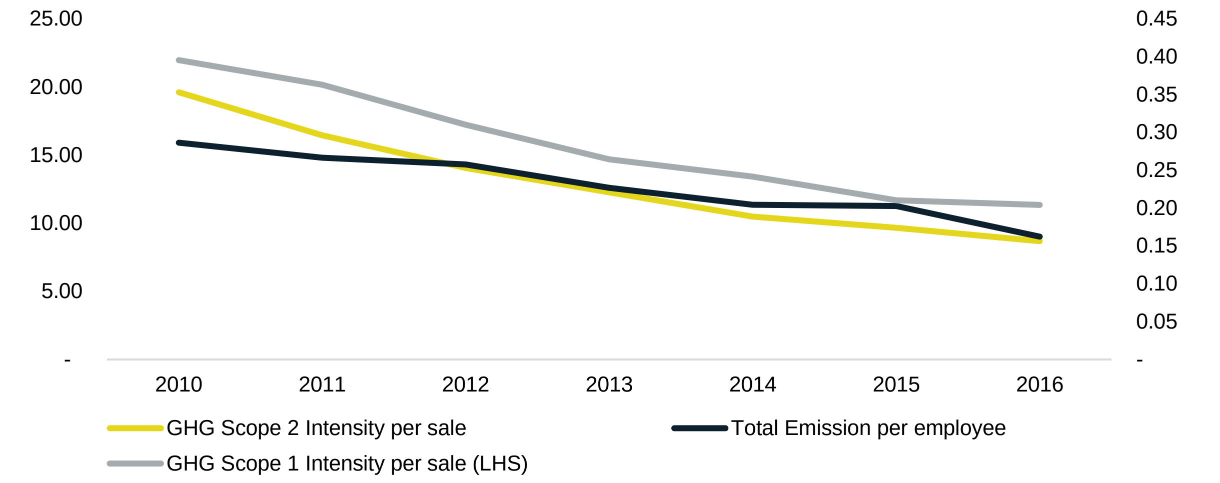
TFG has also focused its efforts in growing its local merchandise supply chain which now constitutes c40% of total TFG merchandise. Through localisation of supply, TFG will not only improve its efficiencies by reducing lead times but also improve the local textile industry by bringing jobs back to textile manufacturing. In addition local designers are being up-skilled through TFG’s in-house design and manufacturing facility which co-ordinates production through their own factories as well as through various independent cut, make and trim (CMT) factories.

[4] TFG 2016 Sustainability Report
[5] https://about.hm.com/en/sustainability/get-involved/recycle-your-clothes.html
[6] http://www.tfgcsi.co.za/blog/feel-good-project-0

TFG ESG highlights

TFG has made significant strides with regard to its performance on ESG related issues. First and foremost, TFG's disclosure on ESG issues through its Sustainability Reports provides far more information and clear targets to judge progress relative to SA peers.

Figure 1: TFG Emission Intensity



GHG Scope 1	:	emissions that come directly from the company's process in delivering a product or service, i.e., fuel combustion from own cars.[7]
GHG Scope 1	:	emissions from other entities that provide products or services, i.e., consumption of energy in the form of electricity, steam, etc.[7]
Total emissions	:	the sum of GHG Scope 1 & 2.

Figure 1 depicts some of TFG's highlights relating to greenhouse gas (GHG) emissions. Since 2010, GHG Scope 1 and 2 intensity per sale have declined tremendously by 48% and 56% respectively. This implies TFG's revenue growth has outstripped GHG emissions. Therefore the company has become more efficient in generating revenue without emitting more GHG. TFG employees have also become more efficient as depicted by the 43% decline in the total emission per employee. The numbers above exclude all recent acquisitions such as Phase Eight and Whistle.

[7] https://en.wikipedia.org/wiki/Carbon_emissions_reporting