S&P Global Ratings

This case study involves a hypothetical entity and is intended for demonstration purposes only. It does not represent an ESG Evaluation for any actual entity. The opinions and supporting commentary are illustrative and could change if applied to real entities.

Environmental, Social, And Governance (ESG) Evaluation

Apparel Retailer Inc.

Executive Summary

Apparel Retailer Inc. (ARI) is a large apparel retailer operating stores nationwide. The company has a vast physical footprint consisting of over 100 million sq. ft. of retail space, 200,000 employees, and over 150 million customers, as well as a significant manufacturing scale and distribution network. The company sells a wide range of merchandise, including apparel and accessories (men's, women's, and children's), cosmetics, home furnishings, and other consumer goods.

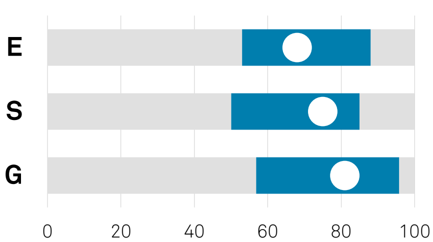
The company's ESG evaluation score of 75 reflects Adequate Preparedness combined with a solid ESG profile. A strong governance framework, demonstrated expertise and track record in managing social factors, and leading diversity and inclusion initiatives across management and the workforce support the company's overall ESG Profile of 75. The score is dampened by environmental reporting practices, which lag industry leaders, and a relatively higher exposure to environmental risk than peers given the size of its physical footprint. Providing more detailed reporting on greenhouse gas (GHG) emissions and waste/water management, more environmentally and socially conscious merchandising and marketing, and closer alignment of management incentives with ESG initiatives could improve the overall ESG Evaluation.

The company's operations have been relatively free from controversies for several years.

Entity	Apparel Retailer Inc.
Location (HQ)	U.S.
Primary Operation Location(s)	U.S.
Publication Date	April 11, 2019
Primary Contact	
Secondary Contact	

Profile Score

75/100



Company-specific attainable and actual scores

Preparedness Opinion

Adequate

Awareness:	**Good**
Assessment:	**Good**
Action:	**Good**
Culture:	**Good**
Decision-making:	**Good**

ESG Evaluation

75/100

ESG 100 represents lower risk exposure

Component Scores

Environmental Performance		Social Performance		Governance Standards	
Sector/Region Risk Level	38/50	Sector/Region Risk Level	35/50	Sector/Region Risk Level	31/35
Greenhouse Gases	Good	Workforce & Diversity	Strong	Structure & Oversight	Strong
Waste	Strong	Safety Management	Strong	Code & Values	Strong
Water	Lagging	Customer Engagement	Strong	Transparency & Reporting	Good
Land Use	Good	Communities	Strong	Cyber Risks & Systems	Good
General Factors (optional)	None	General Factors (optional)	None	General Factors (optional)	None
E Profile (30%)	**68**	**S Profile (30%)**	**75**	**G Profile (40%)**	**81**

ESG Profile (incl. any adjustments) **75/100**

Preparedness Summary

We view ARI's preparedness as Adequate. The company is committed to sustainable practices with respect to its suppliers, customers, and employees and has taken several steps to reduce waste across its facilities and operations. However, despite being aware of the steps needed to utilize resources more efficiently, the company's ability to take quick action and switch gears in light of changes in how consumers shop has been behind other leading retailers. The company developed a three-phase plan to reduce total energy use, improve resource management, and improve construction through sustainable building materials and waste diversion. Nevertheless, the environmental sustainability plan is short-term, with no clear deadline beyond 2018 to accomplish the third phase of the process. The company has not issued an updated sustainability report since April 2017.

Preparedness Opinion **Adequate**

ESG Evaluation

ESG Profile	**75/100**
Preparedness Opinion	**Adequate (0)**
Further Adjustment (if any)	**None**

75/100

ESG Profile

75/100

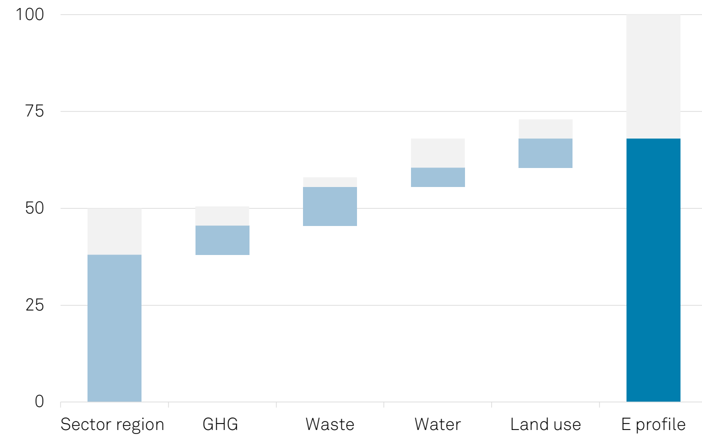
Overview

ARI's Environmental Profile of (68) reflects its commitment to reducing total energy use by installing LED lamps. Furthermore, together the company's outlets constitute one of the largest solar power producers and consumers in the apparel sector in the U.S. The company is also committed to managing waste through packaging reduction and recycled building and marketing materials. However, ARI does not have effective tracking or reporting mechanisms and lacks formal oversight from the board on environmental issues, which constrains the environmental score. The company holds its suppliers to strict product sourcing and labelling standards but does not track (or manage) the suppliers' impact on the environment. Water management, land use, and biodiversity policies are also absent, although to our knowledge there have been no material environmental events in the past decade.

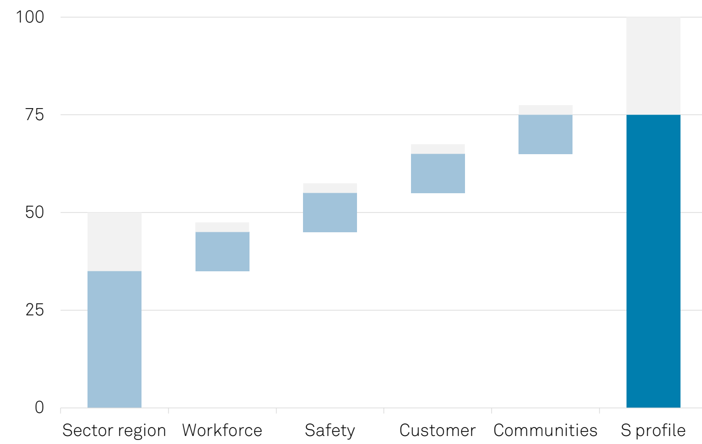
ARI's Social Profile of 75 reflects the company's commitment to diversity and inclusion across all levels of the business including its employees, suppliers, customers, and surrounding communities. ARI takes necessary steps to ensure the health and safety of its workforce, which consists of over 200,000 employees, through training, development, and mentorship programs. The company tracks gender and racial diversity at the workforce and senior rank level, and supports minority and women-owned suppliers. We believe the company holds its suppliers accountable to the same social standards it sets for itself including product safety, child, forced labor, wage, and unsafe working condition standards. Compared to peers executive management compensation is less clearly linked to positive social outcomes such as data privacy, human rights, and product safety.

ARI's Governance Profile of 81 is bolstered by the company's commitment to diversity and industry-leading transparency and reporting practices. The diverse and largely independent board and its committee structure are in line with peers in the U.S. ARI publishes an annual corporate social responsibility report and tracks governance-related fines and regulatory penalties (of which there were none in the last reporting period). The company has a clear purpose and value statement that enhances the overall Governance Profile.

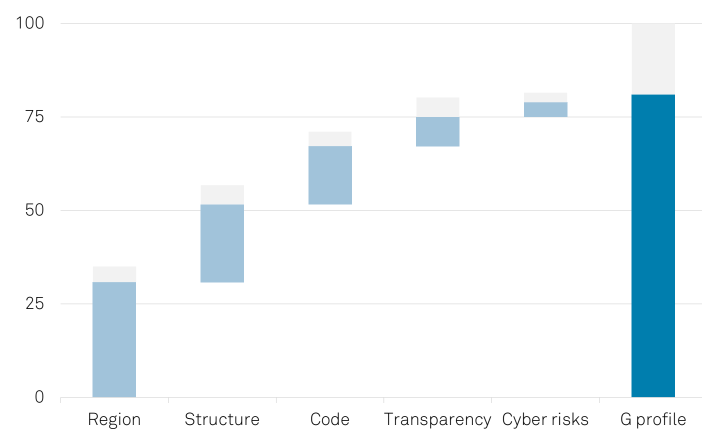
Environmental Profile (30%)



Social Profile (30%)



Governance Profile (40%)



Environmental Factor Analysis

Greenhouse Gas Emissions — Good

- Typical of other retail players, ARI is focused on reducing energy consumption across its store base. The company has installed more than 1.8 million LED lamps and fixtures in almost all of its stores, which cut energy consumption by up to 70% and resulted in savings of about 26 million kilowatt hours in 2016. In addition, the company has a reasonable plan to increase solar energy use and has generated industry-leading amounts of solar power, selling most of it to others. These factors should improve its GHG profile compared to peers over time.
- However, the company has no overarching GHG emissions policy and doesn't track heating or air conditioning use. A lack of demonstrated commitment to improve GHG emissions and related disclosures to stakeholders indicate management is less focused on reducing GHG emissions.
- There is no clear allocation of environmental responsibilities at the management level and no evidence of training on the causes of GHG emissions at the staff level, which further exposes the company to future carbon risk. Nonetheless, we believe the company is moving in the right direction with its commitment to improving energy intensity across its building portfolio.

Waste — Strong

- The company has capitalized on its large size and scale to become an industry leader in retail waste management and has demonstrated a commitment to improve corporate waste management practices across its supply chain. We believe the company compares positively from a waste management perspective to smaller players as it has clear waste reduction targets and public reporting practices, which increase staff awareness.
- The company has established goals to increase the amount of waste diverted from landfills and tracks this data through a sustainability checklist database. ARI has committed to reducing waste in the merchandise supply chain by standardizing the size of packing cartons and incorporating recycled materials into garment labels, as well as using recycled construction waste on major building projects.
- The company has met or exceeded its waste management targets since setting them in 2013 and we are not aware of any reports of poorly disposed waste in the past several years.

Water — Lagging

- The company has no overarching water management policy and does not consider regional water stress in its supply chain and procurement decisions, despite relatively high exposure in its cotton and apparel supply chain.
- We believe its focus on offsetting carbon use with solar power systems will have the side benefit of reducing water use intensity over the next decade as solar panels do not use any water to generate electricity, but water management does not appear to be a key focus of the company's long-term strategic plan.
- If the company effectively works with its suppliers to establish and maintain transparent water management policies and practice, we could improve the water assessment.

Land Use — Good

- The company doesn't have a land use and biodiversity policy, nor does it track or disclose any related metrics or use natural capital protocol to assess environmental impact of its assets.
- Land use and biodiversity risk exposure is generally high for the U.S., indicating one of the largest numbers of endemic and endangered species given the population density and degree of development.
- However, the company is committed to ensuring its products are produced, obtained, and used in a socially responsible manner. The company does not source conflict minerals including coltan, gold, cassiterite, and tin directly from mines and requires the cooperation of its private-label suppliers to implement and execute these processes. A key driver for Good Land Use is our expectation that the company will start to monitor suppliers' compliance with these standards.

General Factors (None)

- We have not made any adjustments to the Environmental Profile.

Social Factor Analysis

Workforce & Diversity — Strong

- ARI's commitment to diversity is well demonstrated: women and ethnic minorities represent 75% and 60% of the workforce, respectively, and more than 65% and 40% of management. Of the board of directors, 45% are women.
- Through the company's Supplier Diversity Program, ARI identifies and supports emerging minority- and women-owned businesses and marketing agencies to ensure proper concept and promotional development. Other large businesses in the region have launched similar programs.
- ARI has demonstrated expertise and a successful track record in managing its large workforce. The average length of service for executives and hourly associates is 10 and five years, respectively, which is significantly better than the industry average.
- ARI conducts an annual employee engagement survey that it uses as an essential tool to increase dialogue between management and associates. ARI applies the survey feedback by developing action plans to address employee concerns. For example, ARI gives associates power over scheduling and freeing up manager time from less value-added tasks. ARI's efforts have reduced staff turnover by over 30% in the past several years.

Safety Management — Strong

- Policies are in place to oversee occupational health and safety. In 2016, the company reported 1,200 hours of lost-time from work-related accidents. While this is a relatively low number compared to the size of its workforce, the number of workplace safety and health violations has remained stable over the past few years.
- ARI is a founding member of the Alliance for Bangladesh Worker Safety, a five-year initiative formed in 2013 by more than two dozen American retailers after the 2013 Rana Plaza building collapse. The initiative is focused on fire and building safety inspections, worker training (with 1.6 million workers trained), and worker empowerment, and ensures safety improvements are technically sound and sustainable. The company is reviewing how the learnings from this initiative can be applied to other regions.
- The company requires multiple types of audits at factories that are contracted to produce ARI's private-brand goods. These audits include quality assurance and social compliance inspections. A key driver for Strong Safety Management is our expectation that the heightened focus on safety in the supply chain will continue to develop.

Customer Engagement — Strong

- Because the retail industry is customer-facing, it requires a level of engagement with customers that goes beyond that in many other industries. Changing demographics and customer trends leave ARI subject to extra risk.
- The company consistently tracks both customer satisfaction and complaints through customer surveys. ARI has made significant progress integrating customer feedback into its operations, e.g. it has introduced technology across all platforms including in-store, online, and mobile to improve customer experience. In addition, ARI is committed to multicultural marketing and communicates targeted brand messages to its large and diverse customer base.
- ARI has increased the amount of merchandise sold under its proprietary brands, which improves its ability to manage manufacturing facilities and protect its reputation. Still, ARI doesn't have direct control over its national brand suppliers, which exposes ARI to claims or complaints from customers.

Communities — Strong

- ARI has a strong brand in local communities, not just because it spends more than peers and supports thousands of nonprofit organizations each year through a combination of corporate donations, employee contributions, and cause marketing programs. The company allocated over $486 million to community organizations in 2018, representing just under 1% of sales.
- The company has a strict antislavery process that applies to both itself and the factories that produce its private-brand merchandise. It's also a longtime corporate sponsor of the Human Rights Campaign, which recognized the company as one of the best places to work from a corporate equality standpoint in 2017.
- ARI has elevated exposure to human rights breaches in its supply chain, and its limited supply chain visibility--specifically for its national brands suppliers--constrains our assessment.

General Factors (None)

- We have not made any adjustments to the Social Profile.

Governance Factor Analysis

Structure & Oversight — Strong

— Nine of the 11 directors are independent. The board of directors has a lead independent director structure with independent committees overseeing management and key issues such as strategy, risk, and integrity.

— The structure and composition of the board and executive team are aligned with ARI's commitment to diversity and inclusion. Nearly a third of ARI's directors are ethnic minorities and five directors are female. Directors have a range of skills, backgrounds, and experience.

— The company as many key policies in place including anticorruption, whistleblowing, antifraud, business conflict of interest, external audit rotation, and business cyber security.

Code & Values — Strong

— In our view, ARI maintains a strong and compliant culture that promotes organizational cohesion and employee engagement. The company has a detailed employee code of conduct and upholds industry-leading ethical business practices.

— The company tracks and discloses senior management remuneration, as well as the pay gap between the CEO and average worker, a level of transparency that we do not see often.

— The company recognizes the importance of the customer in its value statement, which guides it in aggressively implementing customer-centric strategies. ARI does not address environmental concerns in its value statement.

Transparency & Reporting — Good

— ARI publishes an annual corporate social responsibility report and tracks governance-related fines and regulatory penalties (of which there were none in the last reporting period). It also requires independence of external auditors, reports under U.S. GAAP, and discloses all taxes owed and paid.

— Transparency is somewhat weaker for environmental metrics, but we believe this partly due to the lack of standard comparable metrics for the industry. The company does not apply $C0^2$ emissions accounting and could publish more detailed emissions, waste management, and water usage statistics. The company is implementing new technologies to better track non-financial metrics to strengthen its reporting in this space, and we expect transparency to continue to improve.

Cyber Risks & Systems — Good

— We assess ARI's risk level regarding cyber risks and believe it has good operating standards to manage cyber risk.

— However, the company is not immune to cyber-related security incidents given the extensive use of payment processing systems and personal data and highly valuable intellectual property. A severe enough incident could hurt the company's reputation and disrupt business processes. We believe cyber and system-related risks will increase as omnichannel continues to grow.

— In 2017, a small number of ARI's customers were affected by a credit card data breach. In response, the company has implemented additional security measures and has offered consumer protection services to all affected customers.

General Factors (None)

— We have not made any adjustments to the Governance Profile.

Preparedness Opinion

Preparedness	Low	Emerging	**Adequate**	Strong	Best-in-class

Awareness	Developing	**Good**	Excellent
Assessment	Developing	**Good**	Excellent
Action	Developing	**Good**	Excellent
Culture	Developing	**Good**	Excellent
Decision-Making	Developing	**Good**	Excellent

Summary Opinion

We view ARI's preparedness as Adequate. The U.S. retail industry is in the midst of a secular change driven by the rapid expansion of e-commerce and changing customer preferences focusing on value, speed, and convenience. ARI has adopted new technologies, merchandising strategies, and customer service initiatives to meet customer needs and provide a seamless shopping experience. While we believe these initiatives have mitigated near-term risks facing the industry, we believe the longer-term impact of digital transformation and the magnitude and speed of the evolution are not fully addressed. The company would need to demonstrate a more nimble operational strategy and a track record of consistent execution for us to consider a stronger preparedness assessment.

Preparedness Indicators

Awareness	Developing	**Good**	Excellent

The two most heightened long-term risks are technological disruption and changing customer tastes, which we believe will continue to significantly affect the industry into the foreseeable future. A key emerging risk is anticipating how customer needs will trend and adapt. Sustainability initiatives across the retail space are heightening customers' awareness to become more socially responsible.

Assessment	Developing	**Good**	Excellent

In our opinion, ARI has just begun to address the long-term material risks for the retail industry in its risk management and scenario planning process. The company's corporate planning process uses traditional risk analysis tools to identify short- and long-term risks, along with scenario analysis to explore the impact of economic and external changes such as technical, economic, political, and governance trends that could affect its operations. At board meetings, management discusses these risk exposures and the actions needed to monitor the exposures over time. While this process may capture extreme "shock"-type events, it could miss short-term risks with longer-term impacts.

Preparedness

Action

Developing | **Good** | Excellent

The company has implemented several technological initiatives including introduction of buy-online, pick-up in-store, and buy-online, ship-from-store. However, innovation in artificial intelligence (AI), including machine learning and robotic processes, will likely move faster than the company's online merchandising and omnichannel store strategy. We believe ARI's systems are not yet adequately equipped to address the speed, scale, and operational efficiency challenges that come with this risk.

Similar to some of its peers, ARI plans to benefit from stronger messaging on environmental issues (including the potential impacts of climate change and emissions/land regulation shifts) in order to create a more meaningful, socially-focused experience for its customer base.

Culture

Developing | **Good** | Excellent

Social accountability is embedded in company culture at the executive level, with performance metrics closely tied to the company's strategy to create long-term sustainable shareholder value. Board discussions include key risk exposures related to certain financial, operational, IT, and compliance risks, and company performance and strategic plans.

Although the company makes significant investments each year in its training and development programs for its employees, we don't believe a sustainable culture is fully embedded at the staff level. Short-term environmental targets exist although the board doesn't consistently address environmental priorities. And while the company has stabilized its recent performance, we think its merchandise and store strategy has been less effective and nimble at a time when retailing is rapidly evolving and is losing share to "e-tailers." We believe ongoing industry transformation will continue to challenge the company's ability and effectiveness to adapt.

Decision-making

Developing | **Good** | Excellent

ESG factors are clearly articulated in the company's strategy, with more focus on social than environmental given the customer-facing nature of the retail industry. We believe ARI is committed to improving long-term sustainability performance through its investment in omnichannel capabilities, brick-and-mortar store locations, and off-price concept, although the decision-making process has been slower than other industry-leading peers. The goals for strategic initiatives can be measured quantitatively and are meant to drive performance as competition in the retail industry intensifies and customers become increasingly value-seeking. The company's research and development spending is largely allocated to investments in the company's strategic initiatives and technology, with key performance indicators that are comprehensive and consistent with the company's strategy.

Sector/Region Risk

Primary Sector(s)	Retail
Primary Operating Region(s)	U.S.

Sector Risk Summary

Environmental exposure

The environment risks for the retail sector are weighted towards the inherent exposure to direct and indirect impacts from climate change, as well as emissions and land regulation shifts. A key consideration is how changes in consumer behavior could result from climate change and how emissions regulations and land use could affect supply chains. While weather is already a significant swing factor in company's results, longer term, more serious shifts in seasonal shopping and buying patterns could require retailers to adapt product offerings or selling seasons. Emissions regulations are risks since logistics have become more complex for most retailers. Companies face longer-term moderate environmental cost risks, principally because of a long-term trend toward tighter regulation of GHG emissions. The cost to comply, as well as how compliance affects optimal customer delivery options, are risks longer term. A retailer can mix owned and outsourced capacity for logistics, and this provides flexibility to address this risk since lower emission service providers can be selected as providers. Land use risk is an aspect of the both the customer-facing and logistics operations for retailers.

Social exposure

The social exposures for the retail sector are weighted towards customer brand perception, preferences, and demography are risks and opportunities because social and economic factors drive consumer demand for discretionary goods, exception for food, which represents most of the retail product offering. These social risks can be impactful because of the potential immediacy of adverse customer actions stemming from social factors. Opportunities for sales growth or cost improvements could arise if retailers can successfully manage these risks.

Human capital management is critical in this labor-intensive sector as mobile applications and technology change the retail landscape. Accordingly, risks that retailers have to manage include the quality of the customer-facing workforce and an organization's ability to execute change. The compensation, health, and safety of a retailer's direct and indirect (through supply chain transparency) workforce is another social risk consideration for retailers. Social risks and opportunities intersect when retailers address consumers' preference for rapid delivery and price transparency in markets as diverse as urban, suburban, and rural.

Sector/Region Risk

Regional Risk Summary

With robust institutions and rule-of-law standards, the U.S. demonstrates many strong characteristics but lags several other countries with respect to ESG regulations and social indicators. Income inequality is higher than in other OECD countries, but has been so for over a century. Social services are similarly less generous than in most wealthy countries. Governance is characterized by a very stable political system, strong rule of law, a powerful judiciary, and effective checks and balances. Conditions of doing business are generally high. The U.S. follows a rules-based approach to corporate governance, focused on mandatory compliance with requirements from the major exchanges (NYSE and NASDAQ) as well as legislation. Exchanges requirements mandate high standards of corporate governance. The NYSE requires companies listing on its exchange to have boards made up of a majority of independent directors and have separate remuneration and nomination committees. However, establishment of formal requirements on ESG reporting are behind those of European countries. While a growing number of companies have an independent chair, the combination of CEO and chair roles is still popular, which can create issues regarding management oversight. Remuneration continues to be a contentious point, because U.S. executive pay dwarves global pay levels. The CEO-to-worker pay ratio is ever-increasing, leading to social tensions and shareholder criticism.