

# Chemical safety in consumer products industries

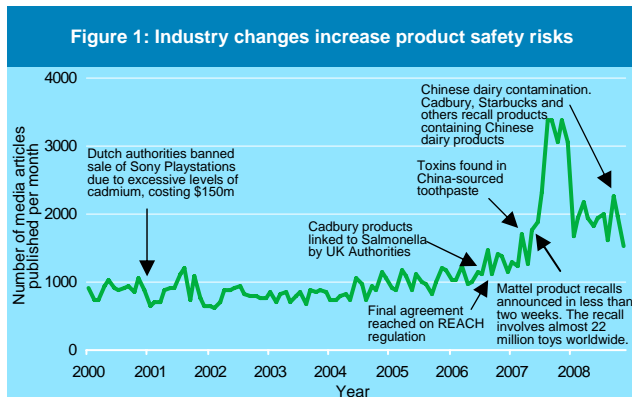
*Sustainable and responsible investment (SRI) is an approach to investment that involves analysts looking beyond immediate market concerns to the underlying structural dynamics that affect sector and company performance over the longer term. This briefing paper summarises research that Henderson's SRI team jointly undertook with Goldman Sachs and looks at the ability of UK-listed consumer product companies to manage the increasing risks associated with product and chemical safety.*

## Consumer products industries have undergone significant changes

Consumer product manufacturers and retailers have arguably been the greatest beneficiaries in recent years of profound changes in the scale and reach of global trade. Faced with rising price competition, companies that previously had direct control over their entire manufacturing operations have embraced the opportunities afforded by liberalised markets and enabled by new technologies to outsource these operations to third parties operating in low cost centres globally.

Outsourcing of production to third parties can, however, result in a loss of oversight and control of the production process. This loss of control is evident in the growing number of product recalls in the UK that have increased by 10% per annum since 2003. There were close to 200 product recalls between November 2006 and October 2007 with 50% of those related to consumer goods (up from 35% in 2003-04).<sup>1</sup> While these issues are apparently recognised by managers in consumer products companies, with over two-thirds of executives reporting a rise in supply-chain risks, only 10% consider their supply-chain management to be very effective.<sup>2</sup>

Coincident with rising risks associated with extended and more complex supply chains, consumers are becoming increasingly aware of – and concerned by – the safety and health profile of products. Media coverage of these issues continues to rise – with spikes in stories associated with specific high-profile issues (see figure 1) – and customer research underlining wider concerns with product and chemical safety. For example, in a July 2006 survey of consumers in seven countries, consultants McKinsey found that 'demand for healthier or safer products' was considered the fourth most important issue in coming years.<sup>3</sup>



Source: Factiva

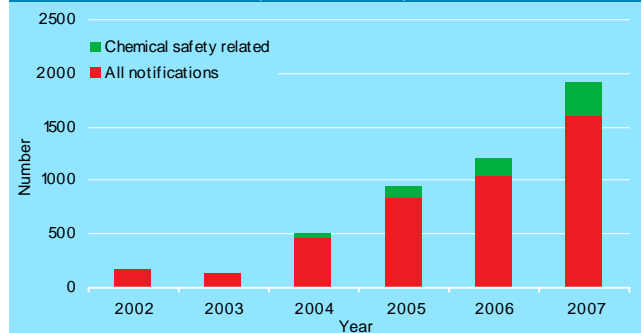
A final trend that serves to further accentuate product/chemical safety risks is the growing proportion of enterprise value (EV)<sup>4</sup> that is based on intangible value. This is particularly true for consumer products companies that typically have greater than 40% of EV attributable to intangible assets such as brands. This value is especially vulnerable to damage caused by product-related or chemical safety risks. In 2007 for example, US toy-maker Mattel was forced into large scale recalls of its products following the discovery of lead and insecure small parts. As a result, Mattel's share price underperformed the sector by approximately 35% in the second half of the year and suffered a 25% derating relative to peers.

## Chemical safety will attract greater attention . . .

While issues of product safety and supply chain risk are now well recognised, it is our view that chemical safety as a related issue is still widely underappreciated by the investment market. The number of non-food consumer products prohibited by the EU Commission on account of safety concerns has increased by approximately 800% since 2002 with the proportion of these bans relating to chemical safety increasing from 8% in 2004 to 19% in 2007 (figure 2).

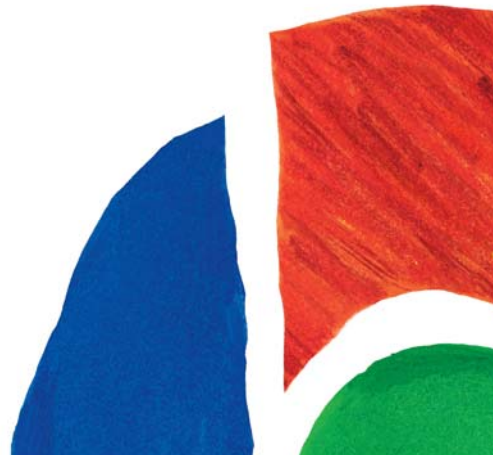
We believe this already strong trend will be significantly reinforced by the growing attention being paid to chemical safety by a range of stakeholders including most notably regulatory authorities and the media. The European Union's REACH<sup>5</sup> system is up and running and an initial short list of hazardous chemicals that will be subject to 'special scrutiny' has already been published. Elsewhere, a number of states in the US have also published legislation aimed at identifying and banning controversial chemicals used in consumer products.<sup>6</sup> This trend is expected to be replicated in a variety of emerging economies including, notably, China.<sup>7</sup>

Figure 2: The number of products prohibited by the EU Commission has risen by over 50% pa over the last five years . . . and an increasing proportion of those bans relate directly to chemical safety concerns



Source: EU Commission

<sup>1</sup> Reynolds Porter Chamberlain LLP.  
<sup>2</sup> McKinsey Survey 2006, Understanding supply chain risk: A McKinsey Global Survey. [http://www.mckinseyquarterly.com/Understanding\\_supply\\_chain\\_risk\\_A\\_McKinsey\\_Global\\_Survey\\_1847?pagenum=4](http://www.mckinseyquarterly.com/Understanding_supply_chain_risk_A_McKinsey_Global_Survey_1847?pagenum=4).  
<sup>3</sup> Op Cit 2.  
<sup>4</sup> Enterprise value (EV) is an economic measure reflecting the market value of the whole business and is one of the fundamental metrics used in business valuation, financial modelling and accounting.  
<sup>5</sup> REACH stands for the Registration, Evaluation and Authorisation of Chemicals.  
<sup>6</sup> For example both California and Maine have agreed new legislation aimed at identifying and prioritizing 'chemicals of concern' with a view to substituting these chemicals with less hazardous alternatives.  
<sup>7</sup> For example see 'EU, China and US in accord on toy safety standards', Financial Times, 18 November 2008

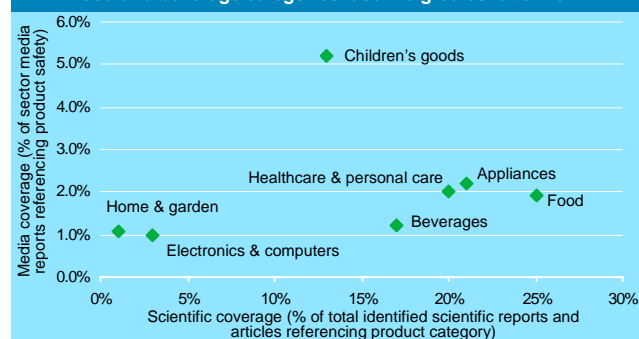


Alongside the now institutionalised processes in place to systematically screen chemicals in the EU and elsewhere, the scientific community's focus on chemical safety risks of particular product categories is growing. For example, the total number of scientific articles focusing on these issues increased from c.2,000 articles in 2003 to more than 10,000 articles in 2007.<sup>8</sup>

### ... but levels of scrutiny are dependent on product categories

However, this level of scrutiny is not evenly distributed across all consumer product categories. Particular categories of products are subject to significantly higher levels of scrutiny than others based primarily on the vulnerability of the group exposed (eg, children and pregnant mothers) and the extent and proximity of contact with the product category in question (eg, food versus garden products). Figure 3 plots relative levels of coverage by the media and scientific communities of particular product categories.

**Figure 3: Children's goods, health & personal care, appliances, food and beverage categories face the greatest attention**



Source: Environmental Health News, Factiva, media & web searches, Goldman Sachs Research

### Assessing company exposure

Our analysis focuses on the relative positioning of major UK-listed consumer product companies to product and chemical safety. Three separate dimensions of performance were considered including two measures reflecting the vulnerability of different companies to product and chemical safety issues. These were:

- Company exposure to products affected by chemical safety concerns based on an assessment of the profile of each company's product mix and,
- The importance of intangible assets including brands to the whole enterprise value (EV).

The third dimension of performance was based on a composite score reflecting a company's ability to manage product and chemical safety-related risks and opportunities. This score was based on a questionnaire submitted to each of the companies.

<sup>8</sup> Environmental Health News, Goldman Sachs Research - 2008

**Figure 4: Questionnaire sent to targeted companies**

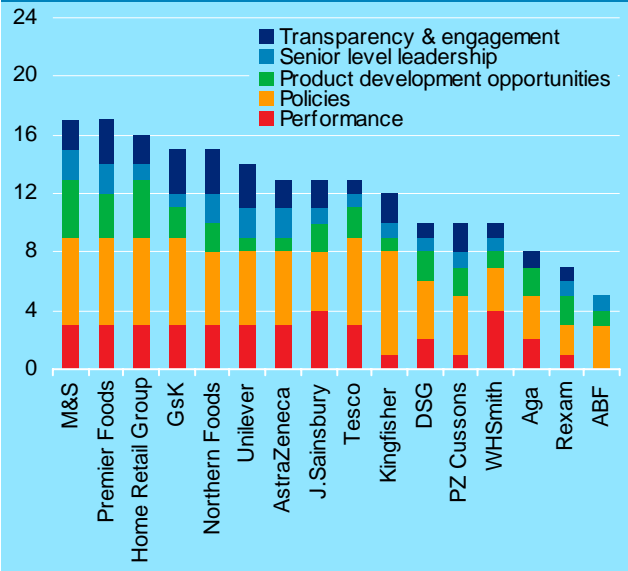
Category	Performance measure
<b>Performance</b>	<ul style="list-style-type: none"> <li>• What percentage of suppliers was audited for manufacturing process safety in the last reporting year?</li> <li>• What expenses did you charge for litigation associated with product safety in your last reporting year?</li> <li>• How many product recalls did you make in the last reporting year?</li> <li>• What percentage of products you buy from third-party manufacturers are tested for product safety, either in-house or by a third-party testing firm?</li> </ul>
<b>Policies</b>	<ul style="list-style-type: none"> <li>• Have you developed procedures for regular auditing of suppliers' product safety standards and use of chemicals of concern?</li> <li>• Have you published supplier safety performance and chemical use requirements?</li> <li>• Do you have an in-house product safety testing group?</li> <li>• Have you published a policy to phase out chemicals of concern, other than those required by regulation?</li> <li>• If so, which chemicals are you phasing out?</li> <li>• Do you use third-party product testing firms?</li> <li>• Have you identified and published a "black list" of chemicals you intend to phase out? If so, can you detail the chemicals covered and the timeline for their phase out, where available?</li> </ul>
<b>Product development opportunities</b>	<ul style="list-style-type: none"> <li>• Have you established safety performance standards for new product development?</li> <li>• Do you have "green chemistry" design criteria for new product design?</li> <li>• Can you provide examples of products you have developed in response to chemical safety concerns in the last year? Can you indicate the expected sales growth for those products?</li> <li>• Can you provide examples of products you have developed based on "green chemistry" principles in the last year?</li> <li>• Can you indicate the expected sales growth for those products?</li> </ul>
<b>Senior level leadership</b>	<ul style="list-style-type: none"> <li>• Has a member of senior management been assigned responsibility for product safety and chemical risk management?</li> <li>• Is compensation of members of senior management linked to product safety performance?</li> </ul>
<b>Transparency and engagement</b>	<ul style="list-style-type: none"> <li>• Have you developed procedures for regular engagement with industry stakeholders on product safety (eg, NGOs, Industry Associations)?</li> <li>• Do you publicise specific product safety policies/initiatives to improve product safety?</li> <li>• Have you established an initiative to educate consumers on the chemical safety of products you or your industry produce?</li> </ul>

Source: Henderson Global Investors  
Goldman Sachs Research

**Ranking company performance**

From the companies' responses, **Marks and Spencer, Premier Foods and Home Retail Group** stood out as performing strongly across all dimensions measured (figure 5). It is also clear that this is already an area where a significant number of companies have made real strides in identifying and managing the risks and opportunities associated with product and chemical safety across a wide range of product categories.

Figure 5: Company exposure to product and chemical safety risk



Source: Henderson Global Investors  
Goldman Sachs Research

Clearly though, effective management of product and chemical safety risks is particularly important to those companies that are most exposed to these risks – determined in our research through an assessment of the exposure of companies to the most sensitive product categories and the importance of intangible assets, including brands, to the company's total market value.

By bringing together an assessment of companies' exposure to product and chemical safety risks with the effectiveness of their management of those risks (figure 6), we can identify companies best placed to achieve competitive advantage through their management of chemical and product safety.

Those companies located in the upper right quadrant in figure 6 are most exposed to product and chemical safety risks and might therefore be expected to have the most sophisticated approach to managing these issues. **Unilever** and **Home Retail Group** for example are both considered to have significant exposure to product and chemical safety risk and, according to our analysis, have developed highly effective systems for managing these risks. **Tesco** and **J Sainsbury** too, on account of the very large variety of product categories that they sell are also arguably relatively highly exposed to product and chemical safety risks. They too, are seen to have reasonably effective risk management systems in place.

In contrast, **ABF** and **Aga** do not appear to have sophisticated risk management systems in place to manage product and chemical safety. This may in part be reasonable as each has relatively low levels of exposure due to the product categories they operate in and the relative unimportance of intangible assets in their EV.

**Rexam** and **PZ Cussons**, however, are both companies that have relatively high levels of exposure to product and chemical safety risk, but at least according to our analysis, have relatively poor systems for managing these risks.

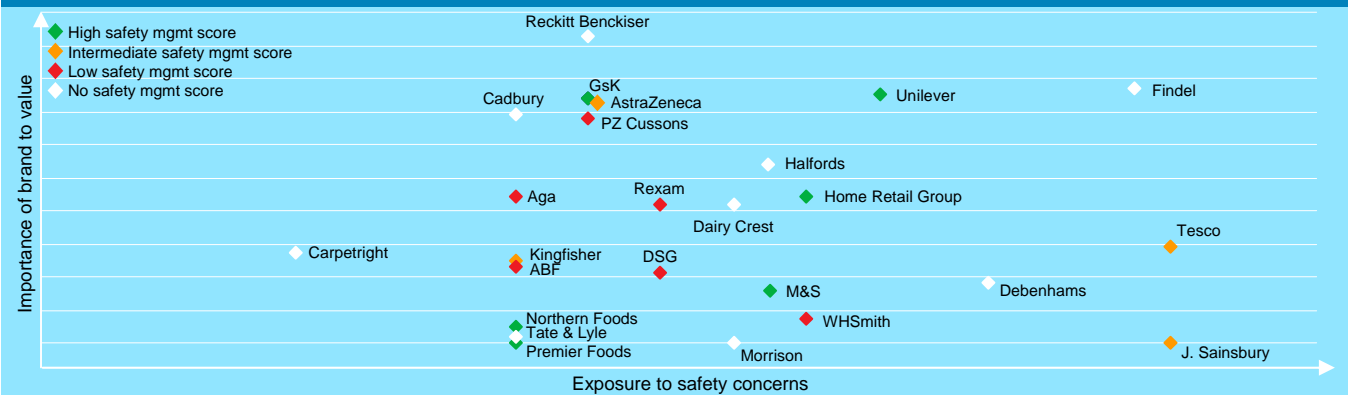
**A word on non-respondents**

Of the 25 companies to which questionnaires were sent, nine failed to provide responses. While we are cautious in reading too much into non-responses, it was clear in our communication with companies that several either did not attach sufficient attention to the issue to respond to our questions or were unable to track their performance in order to provide responses. It is our view that these non-responses may, therefore, represent potential investment risks, particularly for those companies with high levels of exposure, notably, **Findel**, **Halfords** and **Reckitt Benckiser**.

**Risks and opportunities**

While the *risks* associated with product and chemical safety have historically been most visible, there are also clearly *opportunities* to exploit in developing and marketing inherently safer products. We included some questions focusing on this aspect in the questionnaire, but recognise that risk management is likely to remain the key focus in the immediate future.

Figure 6: Company management of, and exposure to, product and chemical safety risks



Source: Henderson Global Investors  
Goldman Sachs Research

## Conclusion

Consumer product industries are both highly complex and diverse in nature and it is difficult to draw direct comparisons between businesses offering such a wide variety of products. Furthermore, product and chemical safety is but one of a wide range of issues confronting these industries and robust investment decision-making must be based on a much broader spectrum of issues. Nonetheless, the effects of rising social awareness of product and chemical safety issues and increasing regulation span the breadth of these product categories and promise to impact companies across markets and throughout the industry value chain.

Furthermore, our research suggests that there is clear differentiation in the effectiveness with which companies are addressing these risks. For some companies with exposure to particularly vulnerable products and a high reliance on intangible assets such as brands for their market value, product and chemical safety is already a critical management issue. Some companies in this subset – notably **Unilever** and **Home Retail Group** – appear well-placed to manage and even benefit from these issues. Others, including in particular **Rexam** and **PZ Cussons**, appear to be much more vulnerable with relatively high levels of exposure, but little apparent capacity to mitigate emerging product and chemical safety risk.

Whilst we recognise that the market performances of those companies will reflect a much wider variety of factors than the effectiveness with which they manage product and chemical safety, the issue does have the potential to significantly affect share prices, and companies are reacting with differing levels of effectiveness. Identifying those companies adapting their strategies and operations to reflect this changing landscape is therefore, we believe, an increasingly valuable input into the investment process.

## Next steps

This research represents an initial step towards an improved understanding of how different consumer product companies are positioned to manage emerging product and chemical safety risk. In itself, we expect effective management of product and chemical safety issues to be insufficient to drive sustained competitive advantage for any of the companies we have considered in this analysis. However, we do expect these issues to become an increasingly important aspect of industry leadership. The beneficiaries will be those companies that are able to effectively address safety concerns and develop products that meet emergent needs in categories for which safety concerns are important to consumers, and ultimately to convert this into superior returns. We plan to further engage with companies to better understand their exposure to, and management of, product and chemical safety risks.

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## Further information

### Seb Beloe

Head of SRI Research  
Henderson Global Investors, 201 Bishopsgate, London EC2M 3AE  
Email: [seb.beloe@henderson.com](mailto:seb.beloe@henderson.com)

### Andrew Howard

Executive Director, Global Investment Research  
Goldman Sachs International, 133 Fleet Street, London EC4A 2BB  
Email: [andrew.howard@gs.com](mailto:andrew.howard@gs.com)

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