Global Asset Management

Modern slavery, exploitation and the issues with low cost sourcing

The RBC Emerging Markets Equity team

"No one shall be held in slavery or servitude; slavery and the slave trade shall be prohibited in all their forms"*

*Article four of the Universal Declaration of Human Rights

What is modern slavery?

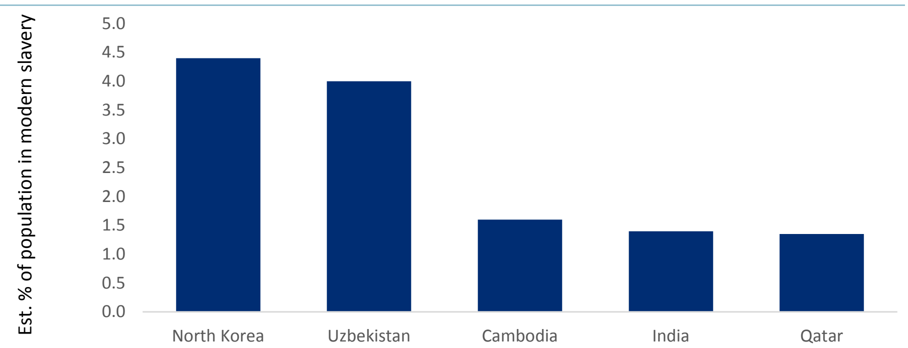
Modern slavery is one of the most serious human rights issues of our time. It is a complex crime which can take many forms. It can range from intentional trafficking of people for commercial gain to child labour and even forcing people to work in hazardous circumstances for no pay. According to the 2016 Global Slavery Index (GSI), it has been estimated that 45.8 million people are in some form of modern slavery in 167 countries. Despite the efforts of governments and NGOs, around the world, the problem continues to grow.

Modern slavery in emerging markets

The issue of modern slavery is especially prevalent in emerging markets. GSI findings show that the countries with the highest absolute numbers of people in modern slavery are India, China, Pakistan and Bangladesh. Furthermore, as illustrated in Exhibit 1, the countries with the highest proportion of the population in modern slavery are North Korea, Uzbekistan, Cambodia, India and Qatar. The statistics for child labour are even more alarming. The Child Labour Index, produced by global risks advisory firm Maplecroft, rated 68 countries as 'extreme risk', with Bangladesh, China, India, Nigeria and Pakistan among the worst. According to the International Labour Organization (ILO), there are 215 million children working throughout the world. Of these, 115 million are victims of child labour and almost half of them work in hazardous conditions.

Exhibit 2, below shows that the majority of child labour cases are in emerging markets.

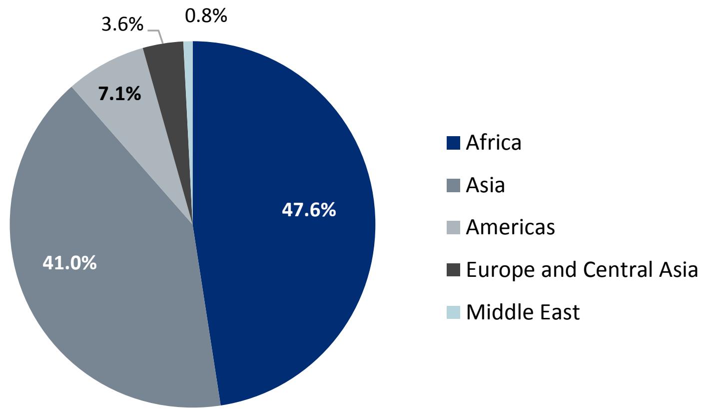
Exhibit 1: Estimated proportion of population in modern slavery by country



	North Korea	Uzbekistan	Cambodia	India	Qatar
Est. no. of population in modern slavery ('000)	**1,100**	**1,237**	**257**	**18,355**	**30**

Source: Global Slavery Index, 2016

Exhibit 2: Child labour breakdown by geography



Source: Global Slavery Index, 2016

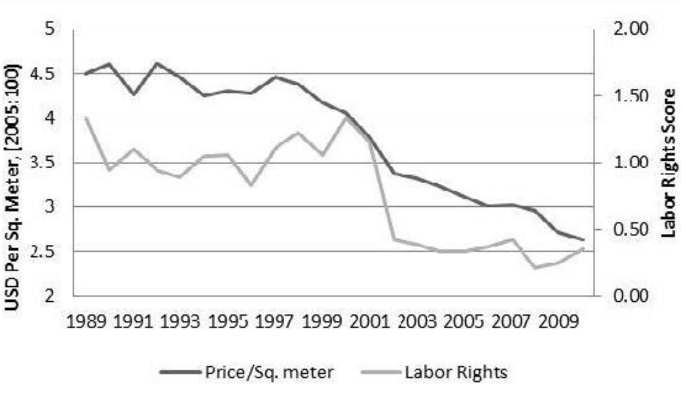
Several recent events have brought modern slavery and exploitative labour practices to the fore. In Bangladesh, the collapse of the eight storey Rana Plaza factory complex in Dhaka resulted in the deaths of 1,100 exploited workers. In Thailand, the seafood industry came under fire after investigations showed widespread slavery, trafficking and violence both on the fishing boats and in onshore food processing factories. Three quarters of migrants working on Thai fishing vessels had been in debt bondage working to pay off an obligation. In China, a worker at GCL Footwear in Shenzhen committed suicide after being fired due to a long-running dispute between workers and management. The corporate and investor communities need to acknowledge that these practices are occurring.

Low cost sourcing

Modern slavery issues and exploitative labour practices are a cause for concern in global supply chains. It has been estimated that 60% of forced labour occurs in supply chains. These instances are particularly prevalent in industries such as agriculture, construction, hospitality and consumer goods. Whilst almost all corporations have no wish to be involved with the use of slave labour, many may turn a blind eye to modern slavery and exploitative labour practices, perhaps hoping to avoid the potentially costly consequences of having to launch an internal investigation.

Studies have found that the lower the cost of sourcing, the lower the associated labour rights. As illustrated in Exhibit 3 below, between 1989 and 2010, the real price of a square metre of apparel entering the USA declined by 48%. Subsequently, the labour rights score declined. These issues cannot be ignored and need to be addressed.

Exhibit 3: Decline of labour rights score



Source: Amer, Blair & Blasi, (2013) Toward Joint Liability in Global Supply Chains: Addressing the Root Causes of Child Labor Violations in International Subcontracting Networks, Comparative Labor Law and Policy, 35 (1), pp. 1-43

Avoiding investing in modern slavery and exploitative labour practices

Modern slavery, exploitative labour and human rights issues are extremely hard to detect in emerging markets for several reasons, including:

A. **Weak Law Enforcement** – in some countries, there is a lack of enforcement of regulations and laws relating to slavery and exploitative labour, with high levels of corruption a significant additional factor.

B. **Cultural Difference** – Suppliers in some countries such as Myanmar and Cambodia (where it is legal for children aged between 14 and 16 to work four hours a day) may believe that they are supporting the local community by employing children.

C. **Worker Perception** – Workers may not necessarily identify themselves as victims of modern slavery or exploitative labour. If they are working illegally, they may not speak up due to the fear of employer retaliation and punishment. There is frequently very little guidance for workers on how they can speak out as there is rarely an obvious platform for them to raise their concerns.

As investors, it is vitally important that we are cognisant of modern slavery and exploitative labour practices, particularly in the supply chain. The RBC Global Asset Management Emerging Markets Equities team has a rigorous process to ensure that we avoid businesses that support modern slavery and exploitative labour practices for the benefits of low-cost sourcing. We constantly engage with management teams and suppliers. Investor research trip will always include, where possible, site and factory visits. These are a crucial component of our due diligence.

We also have a comprehensive checklist where certain questions allow us to focus on modern slavery and exploitative labour issues ensuring we only invest in companies that are committed to building a sustainable value chain.

In the **Strength and the Sustainability of the Franchise** segment of our checklist, there are two relevant questions:

21	Has there been any evidence of cutting corners? (e.g. cheap contractors, child labour, poorer quality materials to save money)
22	Does the company address environmental and social factors responsibly? Is there a formal policy on these matters?

When assessing evidence of cutting corners, it is important to fully understand the practices of smaller, indirect suppliers further down the chain. Companies often use third party agents to manage various parts of the process. It is therefore vital to ensure that when we conduct our bottom-up due diligence, we understand a company's due diligence process with respect to agents and indirect suppliers; understanding this audit process is an important part of our own process. We frequently engage with management teams and suppliers and ask questions related to sub-contracting and the average length of a company's relationship with its sourcing factories. We engage regularly with all our portfolio companies on health and safety with particular regard to any potential improvements they might implement. We also put a strong emphasis on factory visits when we conduct our due diligence on potential investments as this gives us a good understanding of working conditions.

A formal policy regarding social factors is also important when addressing modern slavery and exploitative labour concerns. We look for, and focus on, companies that have a formal Responsible Sourcing Policy. Stronger companies in emerging markets often have an oversight committee to ensure that the value chain is sustainable, efficient, effective and compliant.

Many of these companies also partner with not-for-profit organisations such as the Supplier Ethical Data Exchange and the Ethical Trading Initiative. These partnerships enable companies to collectively tackle issues that cannot be addressed by individual companies working alone.

In the **Management Quality** section of our investment checklist, we address stakeholder management. The key focus here is on supplier engagement: how often the company visits direct supplier factories and what kind of audit is conducted. We also focus on human resource management. Engagement of employees and worker remuneration is particularly important when identifying issues regarding labour rights. Badly-managed workplaces with sub-standard labour conditions are typically inefficient, unproductive workplaces. When we conduct our onsite due diligence for potential investment companies, we try to speak to as many people as possible from the organisation.

When visiting factories, we try to speak to the workers to get a sense of the training they receive, the benefits and the general working environment. This gives us a good indication of the corporate culture and how a company engages its employees. We examine employee turnover trends, as high attrition rates may point to issues regarding the treatment of employees. We also spend considerable time reviewing compensation and how this compares with the average in the industry. In many emerging markets, low pay and long overtime hours are embedded in the business culture and are considered normal. Such issues can lead to employee fatigue and lower productivity.

We want to invest in companies which take a longer term approach and are willing to invest in their labour force and provide a sustainable working environment, regardless of the impact on shorter term profits.

The **Management Quality** section of our investment checklist includes the following questions:

7	Is the company addressing all key stakeholders? How are all the stakeholders in the business treated?
8	How do they engage employees?
11	Are employees paid enough?
13	Does management think about the long term? Is the company prepared to sacrifice short term profit to lay the foundation for future growth?

In the **Corporate Governance** section of our checklist, Audit is a tool we use to address modern slavery and exploitative labour concerns. Audit has emerged as the dominant tool for tackling labour standards in the supply chain. We recognise that audits do not always get to the heart of pressing ethical issues, especially if factories remove evidence of slavery or poor working conditions before auditors arrive. We do, however, believe the following questions, used in conjunction with our other checklist questions, are a useful tool in determining whether unlawful labour practices are being used. Specifically, a red flag is raised if we have found that a company has changed its auditors or signs auditors in a different country to audit its key business operations. This would be a real cause for concern and would lead us to investigate further.

21	Have we seen a change in auditors?
22	Signing an auditor in a different country to key business operations

ABOUT THE AUTHOR

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Zeena is a Portfolio Manager in the Emerging Markets Equity Team in London. Zeena began her investment career in 2007 and joined RBC Global Asset Management in 2009. Zeena has been with the team since inception. Prior to joining RBC GAM, Zeena worked as an investment banking analyst for Lehman Brothers, which subsequently became Nomura. During her time as an analyst Zeena's coverage included a number of emerging markets regions. In 2007, Zeena obtained a BSc (Econ) from the London School of Economics. Zeena is a CFA charterholder.

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