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ESG INSIGHT

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INDOS is proud to provide a range of services for clients who incorporate environmental, social and governance (ESG) considerations into their investment businesses. Our monthly newsletter 'ESG Insight' will provide you with the latest news and views on ESG, helping you to stay on top of developments in this increasing area of focus.

Can we reliably leave ESG data to big players

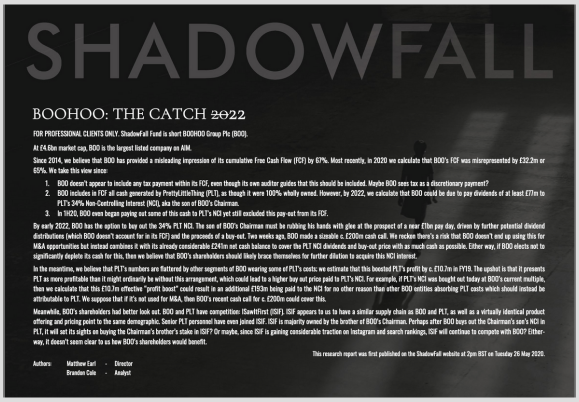
In early July, Wirecard, at its height valued at €28bn, acknowledged that it had a €1.9bn hole in its accounts.

Mid-July, Boohoo, the well-known fast-fashion retailer acknowledged that within their UK supply chain some workers are paid well below minimum wage, attracting claims of modern slavery.

In ESG we are commonly asked what the most important factor is out of the trio. July's headlines show that governance issues remain high on the agenda as in both cases governance issues within the organisation led to oversight and social failures which were not picked up by either audit firms or ESG data providers.

Analysts had been bullish on both stocks for a while. However, these examples look to be another vindication of short-sellers ESG credentials, see ShadowFall report over leaf. According to the FT reports, Wirecard was not as solvent as they were suggesting, and several fashion transparency indexes listed Boohoo in their lowest rankings for traceability of supply chain (see right) and governance. When the retailer can consistently market garments at £3 it is not a stretch to assume worker pay could be an issue, yet despite the sophisticated methodologies of ESG data houses, the ESG ratings did not reflect the underlying issues, such as MSCI's top level rating.

Boohoo is attracting increasing criticism from fashion groups for their practices



SHADOWFALL

BOOHOO: THE CATCH 2022

FOR PROFESSIONAL CLIENTS ONLY. ShadowFall Fund is short BOOHOO Group Plc (BOO).

At £4.6bn market cap, BOO is the largest listed company on AIM.

Since 2014, we believe that BOO has provided a misleading impression of its cumulative Free Cash Flow (FCF) by 67%. Most recently, in 2020 we calculate that BOO's FCF was misrepresented by £32.2m or 65%. We take this view since:

1. BOO doesn't appear to include any tax payment within its FCF, even though its own auditor guides that this should be included. Maybe BOO sees tax as a discretionary payment?
2. BOO includes in FCF all cash generated by PrettyLittleThing (PLT), as though it were 100% wholly owned. However, by 2022, we calculate that BOO could be due to pay dividends of at least £77m to PLT's 34% Non-Controlling Interest (NCI), aka the son of BOO's Chairman.
3. In 1H20, BOO even began paying out some of this cash to PLT's NCI yet still excluded this pay-out from its FCF.

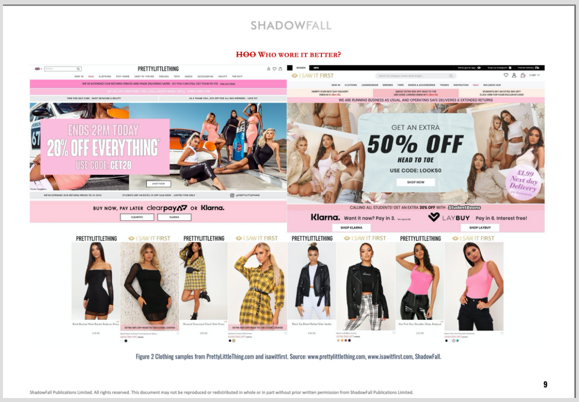
By early 2022, BOO has the option to buy out the 34% PLT NCI. The son of BOO's Chairman must be rubbing his hands with glee at the prospect of a near £1bn pay day, driven by further potential dividend distributions (which BOO doesn't account for in its FCF) and the proceeds of a buy-out. Two weeks ago, BOO made a sizeable c. £200m cash call. We reckon there's a risk that BOO doesn't end up using this for M&A opportunities but instead combines it with its already considerable £241m net cash balance to cover the PLT NCI dividends and buy-out price with as much cash as possible. Either way, if BOO elects not to significantly deplete its cash for this, then we believe that BOO's shareholders should likely brace themselves for further dilution to acquire this NCI interest.

In the meantime, we believe that PLT's numbers are flattered by other segments of BOO wearing some of PLT's costs; we estimate that this boosted PLT's profit by c. £10.7m in FY19. The upshot is that it presents PLT as more profitable than it might ordinarily be without this arrangement, which could lead to a higher buy out price paid to PLT's NCI. For example, if PLT's NCI was bought out today at BOO's current multiple, then we calculate that this £10.7m effective "profit boost" could result in an additional £193m being paid to the NCI for no other reason than other BOO entities absorbing PLT costs which should instead be attributable to PLT. We suppose that if it's not used for M&A, then BOO's recent cash call for c. £200m could cover this.

Meanwhile, BOO's shareholders had better look out. BOO and PLT have competition: ISawItFirst (ISIF). ISIF appears to us to have a similar supply chain as BOO and PLT, as well as a virtually identical product offering and pricing point to the same demographic. Senior PLT personnel have even joined ISIF. ISIF is majority owned by the brother of BOO's Chairman. Perhaps after BOO buys out the Chairman's son's NCI in PLT, it will set its sights on buying the Chairman's brother's stake in ISIF? Or maybe, since ISIF is gaining considerable traction on Instagram and search rankings, ISIF will continue to compete with BOO? Either-way, it doesn't seem clear to us how BOO's shareholders would benefit.

This research report was first published on the ShadowFall website at 2pm BST on Tuesday 26 May 2020.

Authors: Matthew Earl - Director
Brandon Cole - Analyst



The ShadowFall hedge fund led by Matthew Earl, a specialist in taking positions that bet against a company's share price, issued a 54-page report accusing Boohoo of misleading investors about profits and cashflow.

Despite the warning signs of poor accounting and transparency in both firms, some ESG funds reportedly still had exposures to them. Of these the majority seem to be low-cost passive funds which tilt to ESG rather than being actively managed. These funds will use the headline 'ESG' score from a data provider and not invest in a firm below a threshold. If the data provider scores do not reflect the underlying issues then the fund will still invest.

The need for verification of ESG data is growing, firms which exist to randomly sample positions within funds to ensure the reliability of the ratings which many managers use will increase the market confidence.

The EU sustainability disclosure regulation

What is the disclosure regulation

This month we take a brief look at incoming EU regulations on sustainability-related disclosures in the financial services sector (known as the Disclosure Regulation or SFDR).

The Disclosure Regulations form part of several new regulations which are putting sustainability at the heart of the EU financial system and comes into force in March 2021 as a comply or explain regime.

Amongst the requirements, it will require firms to:

1) publish on their website policies about how sustainability risks are integrated in the investment decision making process and how remuneration policies are consistent with the integration of sustainability risks

2) on a comply or explain basis disclose policies and the adverse impacts of investment decisions on sustainability factors

3) make certain or provide evidence for other disclosures particularly in relation to ESG focussed products.

Who would be subject to these rules?

The Disclosure Regulation applies at the firm and the product level in respect of all financial products, and not just those with an ESG focus. The Disclosure Regulation will capture a broad range of Financial Market Participants, including AIFMs, UCITS ManCo's and MiFID firms as well as potentially funds marketed by non-EU managers to EU investors. It will also impact financial products including AIFs, UCITS, managed accounts as well as investment advice.

Will the Disclosure regulation still apply once the UK leaves the EU

The UK is expected to implement the Disclosure Regulations in March 2021. However, the UK government has not confirmed if the next level of EU regulations, the Regulatory Technical Standards, which will be implemented as they have not been released.

There is therefore uncertainty about how UK firms will implement the Disclosure Regulation in practice if the level 2 disclosures are not implemented.

Our firm is a 'financial market participant', is there anything we should be doing between now and March 2021?

Firms should start to formulate their policy on the integration of sustainability risks in their investment process for publication on their websites.

Firms should also assess whether they plan to implement a policy with respect to the principal adverse impacts of investment decisions on sustainability or explain which such impacts are not considered.

There is a large qualitative and quantitative element outlining the adverse environmental impacts of a manager's portfolio such as the carbon intensity and portfolio exposure to water-stressed areas.

For many managers or those without a dedicated ESG analyst, these will be difficult disclosures to undertake. For this reason, we expect many of those looking to fully adopt and comply with the Disclosure Regulation being those for which sustainability and ESG is very aligned with their brand image and therefore they would have the resource to undertake the disclosure.

If you would like to keep on top of ESG developments and receive ESG Insight in your email every month you can subscribe here

For more information contact:

Alex Booth, ESG analyst

+44 (0) 203 876 2346

abooth@indosgroup.com

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