CSI 20/21

CIRCKLO
SUSTAINABILITY
INDEX

Introduction

The Circklo Sustainability Index (CSI) has been produced to help business leaders in consumer industries better understand how the top 50 companies in the world perform across three dimensions: digital acceleration, financial performance, and circular integration.

This Index will also help business leaders understand:

- Digital transformation imperatives
- Environmental and Social Governance (ESG) terminology relevant to business operations
- The role of annual reporting to address financial and non-financial metrics
- Circular business models

The Circklo Sustainability Quadrant aims to better inform the debate about the transition to sustainable business, and is a practical tool to measure progress achieved year on year. It can also be a helper for smaller companies to benchmark their efforts against corporate leaders in this area.

Let us know your thoughts, suggestions and questions to ideas@circklo.com

About Circklo

Set up in London in 2020, Circklo created the first Business Configurator in the world specialised in digital start-ups for the circular economy. Circklo's main expertise is in developing seed stage start-ups in the sustainability area. It offers start-ups both the opportunity to raise capital and accelerate their business and, also, to configure their business in such a way that purpose and profit can successfully coexist and complement each other in the 21st century digital world, fully using and embracing the principles of circular economy.

Executive Summary

This Sustainability Index is meant to provide a useful tool to help in benchmarking business sustainability against the performance of the largest companies in the consumer industries sector. To create the Circklo Sustainability Index (CSI), we have used input data that are independent of the size of the company itself, thus this methodology can be used to score companies of any size.

In our opinion, in order to be sustainable, a business must show high standards of corporate purpose and circularity, as well as strong financial performance. To these two dimensions, operational and financial, we added a third crucial 'ingredient' for sustainability, which is digital acceleration. We pooled Circklo's resources and experience in these three areas to analyse and score the 50 largest companies in consumer industries in North America and Europe. These scores were used as the foundation for the calculation of the CSI score.

- The highest-ranking companies are Circklo's Pathfinders. They tend to score highly in all three dimensions and are the leaders in sustainability. Rather surprisingly, only one company deserved the label of Pathfinder 20/21.

- One step below are Circklo's Change Champions, which tend to have a clear sustainability strategy and good execution but have a gap to fill in one of the three dimensions that form the Index. Five companies made it into the Change Champions 20/21.

- Lastly, Circklo's Challengers, a broad category ranging from companies that have developed a sustainability strategy but are behind in terms of execution (a handful of which are very close to the Change Champions category) down to the ones that have yet to formulate a sustainability strategy.

The Circklo Sustainability Quadrant 20/21 is the summary of our CSI findings. It shows, in a pictorial format, the top 10 companies that made our quadrant this year.

Image courtesy of Henkel

Image courtesy of Amazon

Defining Circklo's Sustainability Index

At Circklo, we believe that a sustainable business is defined not simply by its products and supply chain, but also by its financial performance and its degree of digital integration.

Financial success is often the main focus of investors, but it becomes unsustainable in the long run if there is no ability to create a circularised supply chain and demonstrate it to the customers and consumers through an efficient digitalisation of the business. Circularity, financial success, and digitalisation feed into each other in a virtuous loop, and together can drive the development of truly sustainable business models.

A natural consequence of this vision is the idea of creating a quantitative benchmark to help companies, investors and professionals to assess the level of sustainability of businesses based on those three dimensions. Sustainability is a very complex topic, and the creation of the Index required us to pool together our professional experience in digital acceleration, circular integration, and financial analysis.

We have focused on the 50 largest companies in consumer industries in Europe and North America. We have analysed and scored each company on those three dimensions separately, in an objective manner, and then combined the three scores into a single score (CSI) that was used to generate the final ranking. We have based our assessment on publicly available data, given our belief that consumer industries should be willing to communicate their achievements to customers and consumers, i.e. the public. We have selected the parameters and quantities that, in our judgement, best reflect the three dimensions that we wanted to measure. The sections below will be giving more details regarding our methodology and results.

Our aim is greater than ranking companies and celebrating the winners, we want to establish a tool that embodies our view of sustainability in a quantitative manner. We would like the CSI to help generate constructive discussions and motivate companies and people to accelerate their business transformation towards sustainability.

Digital Acceleration

The primary source for the Digital Acceleration scoring were the annual reports of the 50 companies that we have included in our Index this year.

Many of the companies analysed demonstrated solid evidence that sustainability is a journey that affects businesses, people, and cultural phenomena in society. However, only a minority of companies in consumer industries are starting to realise the importance of digital transformation to achieve their sustainability goals and to improve performance by adopting use cases such as:

- Market and consumer trends measurement and forecast
- Brand impact on sustainability by source of materials
- Customer business rules for combined shipments
- Curated subscription and sharing economy models
- Carbon footprint analysis of collections and categories
- Extension of the product lifecycle
- Adoption of design concepts for long living products and sustainable packaging
- Implementation of one unified production process across different channels and operating models
- Integration of ESG metrics into annual report
- Customer and partner involvement in circular business models

Despite the evidence presented in the annual reports that the digitalisation of business processes in consumer industries is highly centred in non-circular business models and/or non-sustainable practices, a few companies have excelled in this dimension.

Digital transformation is not dependent on sustainability, but **sustainability should be the digital transformation theme for all companies that aim to trade with purpose**.

Image courtesy of Inditex

In order to produce a score for digital acceleration, we have looked at digital core investment size, evidence of digital innovation, the quality of programs created for customer digital experiences, and social media strategy.

The vast majority of companies from our Index did not perform well in the social media area (with an average score of just 41.2 points) which may indicate a lack of understanding of social media at a strategic level. We did not look at social media as external channels only; we also considered owned media such as communities.

In the digital acceleration score, the component that performed better was the digital core investments with an average of 58.8 points. It is perhaps easier for companies to disclose digital investment information in the annual reports than their social media strategy, but we believe that companies cannot continue to treat social media only as an operational tool, and so we expect improvements in this area in our next edition of this Index.

The highest ranking businesses in the digital acceleration score were:

• Amazon: 90 points
• Inditex: 82.5 points
• Nike: 82.5 points

Amazon's marketplace strategy has been highly digitalised since inception, so it may not come as a surprise that *Amazon* scored higher than anyone else in this dimension (90 points). Many companies worldwide take *Amazon* as an example of what good looks like when it comes to defining their own digital transformation use cases. It is also important to take notice that this digital giant has set up new standards for everyone in retail over the past few years, with next day delivery and subscription models for product and service bundles.

In the top three for Digital Acceleration *Inditex* and *Nike* each scored 82.5 points. They have very different business models from *Amazon*, and very different business models between them, but it was interesting to see how a brick-and-mortar retailer and a sports brand were able to score almost as high as *Amazon* in an area where traditionally they were not leading.

Is *Amazon* losing the 'world domination effect' as other companies sophisticate their digital operations? Or will *Amazon* continue to rank higher than anyone else due to economies of scale gained over the last decade? This is a trend we will continue to analyse in future editions of our Index.

Inditex reports reveal **a maturity and an understanding of supply chain like no other company in this Index**. The investment in digitalising the business has been consistent over the years and, since 2018, the company embarked on a process of digital transformation and sustainability-driven innovation with the objective of becoming a fully sustainable digital platform for customers worldwide. This is the company that better demonstrated a strategic connection between digital transformation and sustainability.

Innovation is one of the cornerstones underpinning *Nike's* business. Technical innovation in the design and manufacturing processes of footwear, apparel, and athletic equipment has received investment over the years as the company strives to minimise waste and extend the lifecycle of its products. With regards to digital platforms, the company has invested in creating communities such as the Run Club and Training club apps, offering practical content related to sport, personalised coaching, and nearly 200 workouts including audio and visual guidance. The company's culture of innovation rooted in customer centric experiences powered by digital platforms is reason enough for a well-deserved place in our top three Digital Accelerators.

Financial Performance

As explained before, our Circklo Sustainability Index combines sustainability and digital maturity concepts with financial performance. We believe that a business that performs strongly from a financial point of view has far better prospects to thrive and be sustainable in the medium and long term. Such a business will also have more capital to invest in sustainable products and processes and, therefore, be a long-term winner. Conversely, a sustainable and digitally mature business should be better positioned to deliver stronger financial results in the medium and long term. Therefore, any real-world analysis of business sustainability has to include an objective quantitative measurement of companies' financial success. How do we define 'financial success'?

The Financial Performance section of Circklo's Sustainability Index draws on over four decades of combined investment management experience from two of our financial masterminds. The focus is on medium and long-term financial results, with a time horizon of up to five years. This focus reduces the year to year financial fluctuations and it also rewards businesses with a more consistent performance. It is important to notice that we do not take into account market-driven valuations in our analysis. We solely consider data coming from the companies' income statement and balance sheet, regardless of the valuation that financial markets attach to the business.

The other important point is that we only consider percentage metrics. This allows our assessment to be transferable across companies of different size and geography, and makes our Index relevant as a benchmark for smaller companies. Amongst other things, the Index components that feature more prominently in our analysis are gross margins, operating margins, balance sheet strength, and sales growth.

Gross margins are the difference between the revenues and the costs of producing the products. This is a crucial metric as a high value-added product is likely to have a higher gross margin relative to a low value-added product. High gross margins are a sign of a stronger and high-quality product range and, therefore, a structurally more profitable business model.

It is not a surprise that beauty and fashion industries score very highly in this section, while classic brick-and-mortar retailers do not. The operating margins are obtained starting from the gross margins and subtracting other costs like sales and marketing, administration and general corporate costs (i.e. the costs of running a business). Similar to the gross margins, high operating margins denote a structurally more profitable business that can better face competitive pressure and invest more for the future.

As expected, we observed a very wide range of margin profiles for the companies in our Index, reflecting the huge differences between companies operating in a highly competitive retail industry versus consumer companies producing high value-added products, such as the luxury industry. The brick-and-mortar retailers typically operate at low-single-digit operating margins. At the opposite end, we find companies with strong brands and customer loyalty, delivering staggering margins (e.g. 49% for *Altria* and 35% for *Hermes*). The outlier is *Amazon*, with operating margins at 4%, similar to brick-and-mortar retailers, due to their huge investments in supply chain digitalisation.

As a measure of balance sheet strength, we have looked at net and gross debt relative to EBITDA. Higher amounts of debt, in comparison to the company's operating profit, certainly increase the riskiness of the business. We found a wide range of debt profiles, with several companies running no debt at all versus companies showing high levels of balance sheet leverage (*Anheuser-Busch InBev*, *Keurig Dr Pepper* and *Marriott International* have debt worth five times their operating profits, probably as a result of their aggressive acquisition strategies).

The most important driver of the financial performance contributor in our Index is sales growth. We believe that medium and long-term sales growth reflect a company's ability to gain market share and, therefore, its success, particularly if the sales growth is achieved by preserving or growing margins.

In a world where growth is scarce, consumer companies that can successfully grow their sales have a far better chance to be the winners of tomorrow's sustainable world.

The range of results here is also very wide, and the difference between the new economy and the old economy staggering. There are companies like *Cigna* and *Centene* posting a five-year average sales growth of 50% and 37% respectively mainly due to acquisitions. *Amazon* also excels in this area with a five-year average sales growth of 26%, primarily organic. Here the 'challenged' businesses are food and beverage companies like *McDonald's* and *Coca-Cola* that are showing mid-single-digit sales contraction and a series of consumer companies that have no sales growth whatsoever.

Circular Integration

The Circular Integration (CI) section of the Circklo Sustainability Index analyses the performance of the 50 companies mentioned above across a set of 33 different fields in the area of corporate purpose and circular implementation.

Combining our experience in different sectors, we have identified the relevant metrics and have weighed them according to their relevance to **thoroughly assess the sustainability record of these 50 companies**.

To achieve more granularity in our analysis, we followed a framework generally resembling the classification of the sustainability dimensions defined by the Sustainability Accounting Standards Board (SASB). In particular, we have looked at **Environment, Social Capital, Business Model and Innovation**, as well as Leadership and Governance.

- Environment. For this dimension, we have analysed the environmental impacts associated with the companies' products and services. We have tried to capture as many details as possible. For example, when assessing carbon emission, we explicitly looked at emissions associated with employee travel and, when analysing waste, we looked at different metrics such as total waste, waste per employee and percentage of waste recycled.
- Social Capital. Here we have considered topics like relationships with local communities or human rights records.
- Business Model and Innovation. Emphasis has been put on the companies' investments in innovation and sustainability and, also, on management of the supply chain, especially with regard to environmental and social impacts.
- Leadership and Governance. The way corporates address the interests of different stakeholders and implement principles of diversity and inclusion has become a very sensitive topic. Here, we investigated a number of metrics that we consider best measure performance in this area.

Looking at the data analysed, there are a few trends that clearly emerge.

The most obvious trend is the geographical split. The components of our Index are the 50 largest companies in the consumer sector incorporated in Europe or North America. In terms of Circular Integration, **Europe performs much better than North America**. European companies have an average CI score of 59.1 and occupy the podium for the three best performers (*Diageo, L'Oreal and Henkel*). The American companies, on the contrary, have an average score of 47.3 and fill the lower half of the table with 19 North-American companies in the bottom 20. We do not believe this is just a coincidence, but a consequence of a much more developed sensibility in Europe towards the issues of sustainability, both from a regulatory perspective and a strong involvement of the general public.

Another point that requires some comments is the different granularity in reporting. While the more general information on global emissions or corporate governance is mostly reported by all companies, it becomes increasingly more difficult to find companies reporting more detailed (but still very relevant) information on several other aspects of circularity. It is clear that this requires considerable effort on their side and, where present, it indicates a particular awareness of sustainability issues. It is not a surprise then to observe a strong positive correlation (80%) between the number of reported fields and the CI score of a company: good "reporters" are also good "circular actors".

In terms of subsector trends, we see **better overall performance from companies in the consumer products sector** versus companies in the retail sector. This is not surprising and, probably, it reflects the tougher business environment faced by most of the retail industry. This is particularly evident in the high dispersion of scores in fields related to environment and carbon emissions again with retail companies typically performing poorly. On the other hand, fields related to general governance issues have a lower dispersion of results and do not have obvious subsector trends.

It is encouraging to see a number of positive readings in the report. Most of the companies have initiatives in place to address and reduce both the social and environmental risks in their supply chain. And they have guidelines and policies to protect human rights and to implement ethical codes of conduct.

Among the negatives, there are a couple of metrics that we want to highlight. First of all, **only 20 of the 50 companies we analysed are signatories of the United Nations Global Compact (UNGC)**. Citing UNGC's website, this is "the world's largest corporate sustainability initiative - A call to companies to align strategies and operations with universal principles on human rights, labour, environment and anti-corruption, and take actions that advance societal goals". We find it striking that neither *Amazon* nor *Walmart*, the two largest companies in our Index and main representatives of the new and old economies, thought it necessary to put their leadership behind such initiative.

And finally, it is perhaps no surprise that much still needs to be achieved in terms of diversity and inclusion. With an average age of 62 and only an average of 29% for women presence, we conclude that not enough has been done to change the stereotypical image of corporate boards made up of mostly middle aged males.

Image courtesy of Inditex

Measuring Results

In this section we present the results for the first series of the Circklo Sustainability Index. In the Appendix, we present the full numerical results, with the breakdown into the three sub-indices that contribute to the overall score.

Our findings show some clear trends across sectors and geographies and also raise questions on corporates' different approaches to the complex problem of sustainability.

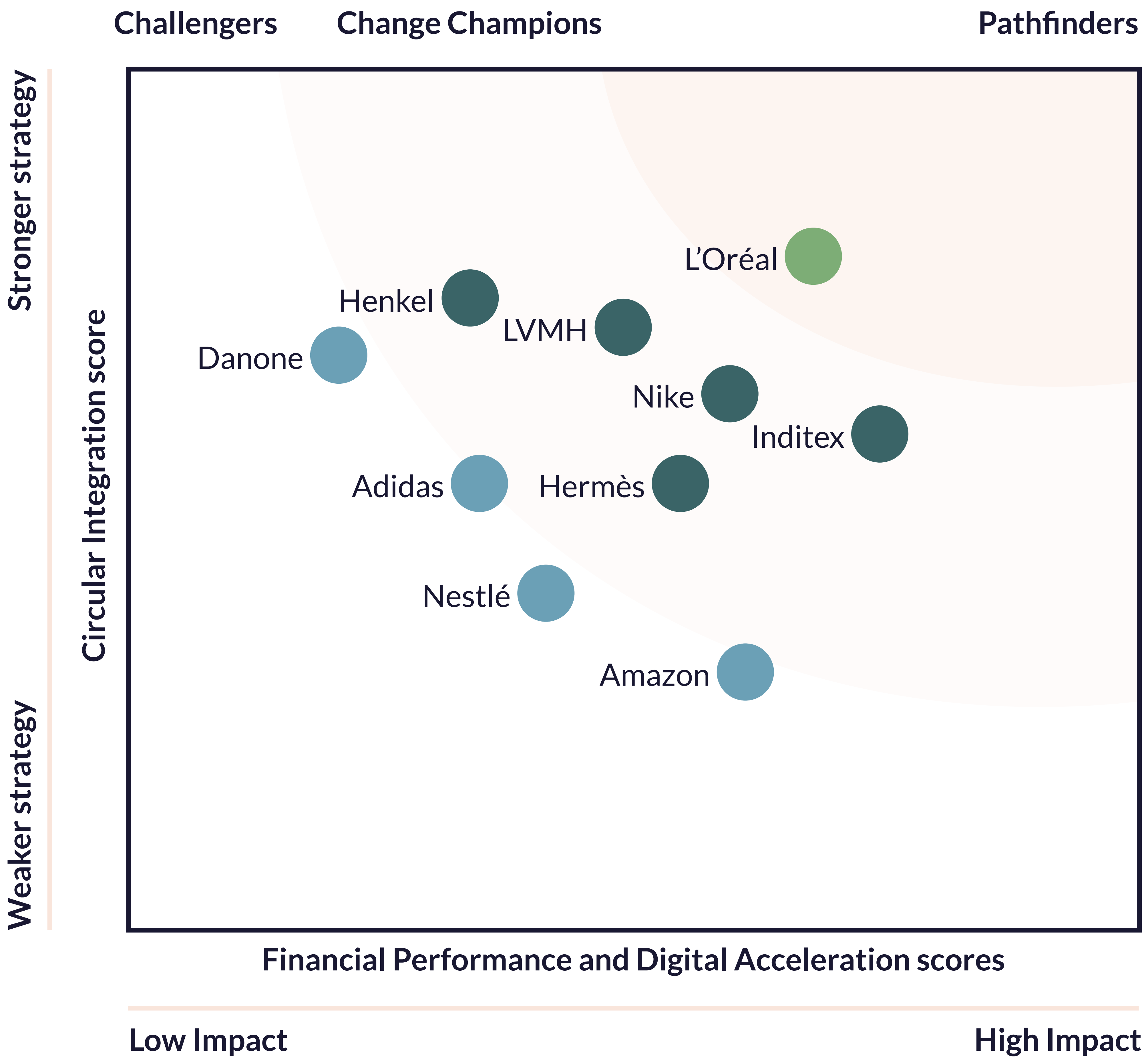
The main aim of our research was to identify the innovators, companies that have both a strong circular integration strategy and high market impact. These companies lead the way in their approach to sustainability and can serve as benchmark and inspiration for others to follow.

One step below are the Change Champions. These are companies that have made considerable progress in their transformative process to become circularly integrated, digitally advanced, and financially sound but are not quite there yet at least in one of these three metrics.

At the bottom of the ranking are the Challengers, companies that have weaker strategies and execution. This is a very broad class and, of course, within it one needs to distinguish between companies that have embraced the change but are slightly behind, and others that are very far from even starting to formulate a clear strategy.

The Circklo Sustainability Quadrant below gives a clear visual representation of the top ten performers.

Circklo Sustainability Quadrant



The first conclusion that can be drawn is that there is huge space for improvement when it comes to businesses becoming more sustainable. **Only *L'Oréal* achieved a Pathfinder score and, of the rest, only five more reached the Change Champions status.**

Looking further into the results, it is clear that only two companies, *L'Oréal* and *LVMH*, managed to achieve a top ten position, both overall and in all the sub-indices.
It is quite striking to see that the correlation between the Circular Integration and the Digital Acceleration scores is low. This suggests that, generally speaking, companies approach these two issues separately and not as part of the same vision to achieve sustainability.

In terms of geographical divide, there is a clear outperformance by the European companies. They have an average score of 54.2 and occupy eight of the first ten positions. On the other hand, North American companies only score 42.8 on average and fill nine of the bottom ten spots in the Index.

It is certainly true that European regulators have shown more sensibility in this area and that European consumers are becoming more and more aware of sustainability issues. But we believe that the momentum behind the drive towards more sustainable models is ever increasing in North America too. It suffices to mention the "Statement on the Purpose of a Corporation" signed in August 2019 by 181 CEOs of American companies, a commitment to "lead their companies for the benefit of all stakeholders". It will be interesting to see how this commitment will translate into better scores in the next iterations of our Index.

A few obvious trends are also evident when looking at the different subsectors. **With an average of 58.2, the apparel & textile segment has the best overall score.** These companies tend to have higher margins and this, perhaps, allows them to invest more resources into their transformation agenda and have better business cases. We would also argue that consumers in this space are particularly sensitive to issues related to the social and environmental impact of what they buy and to some topics around sustainability, like working practices and pollution in the supply chain to name just a few.

While consumer products show a wide range of scores reflecting the different nature of businesses under this category, it is not surprising to see **consistently low scores in the retail sector**. This is particularly true for the consumer staples segment which, with 39.1, has the lowest average score.

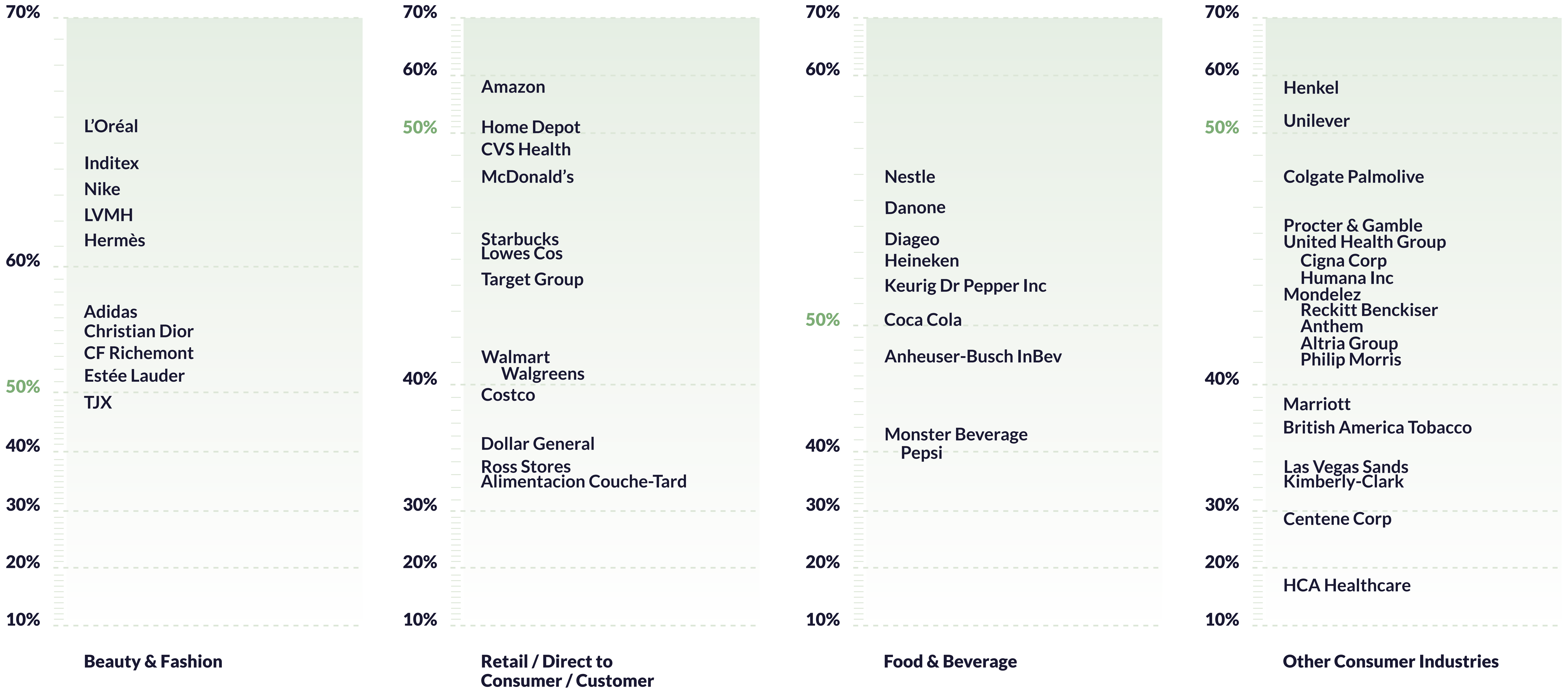
It is clear that the traditional bricks-and-mortar model is under a lot of pressure from different angles. Deteriorating financial metrics are an illustration of business models in structural decline, and they make the implementation of an action plan towards sustainability even more difficult. But should these not be the companies with the highest urgency for developing new sustainable models and for which digital transformation becomes almost an existential need?

What could the future look like for a chain of convenience stores, mainly located in petrol stations, when various nations will be introducing bans on selling petrol cars in the not too distant future.

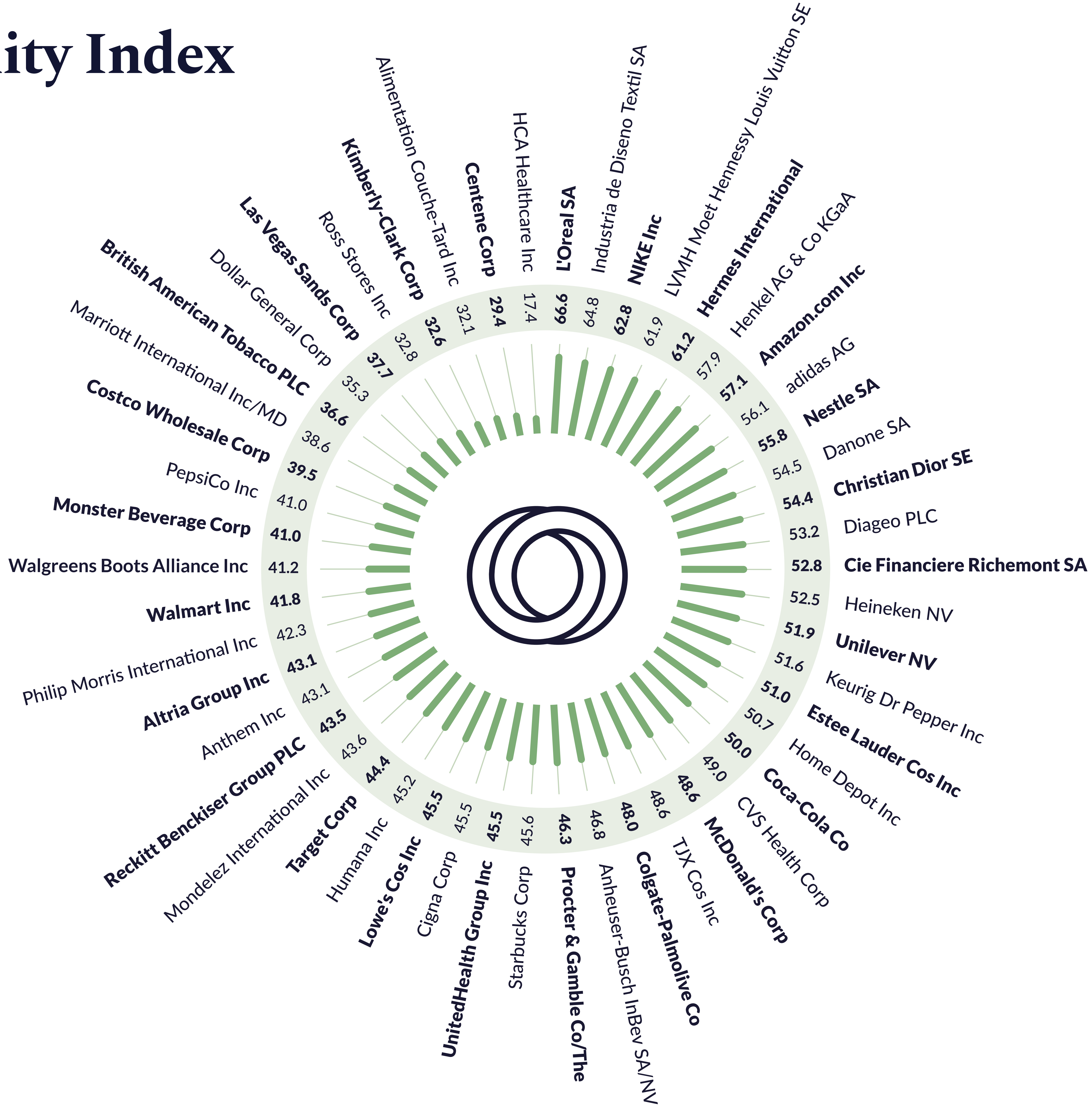
There is no doubt that the debate around sustainability is starting to take centre stage among business leaders, regulators, and consumers worldwide. Many new initiatives are being discussed and implemented, but, what is clear from our findings is that a lot still needs to be achieved.

Image courtesy of Nike Inc.

Circklo Sustainability Index



Circklo Sustainability Index



Conclusion & Key Takeaways

The higher scoring of European based companies clearly reflects the attention present at all levels in Europe regarding sustainability.

The clustering of the scores for the subsectors of fashion, retail, and food & beverage is also unsurprising as it reflects the different strategic importance that each subsector gives to sustainability.

We found surprising the general lack of correlation between the circularity and digital maturity scores. In our view, this clearly shows that environmental and social factors primarily drive the push towards sustainability, and we believe that companies should take a holistic approach and consider digital integration and data utilisation a necessary condition to achieve a sustainable business model.

We find it encouraging that the companies in our ranking belong to very diverse subsectors and have different business models. It is clear that a high degree of sustainability can be achieved in a wide range of businesses, provided the right strategy is in place.

The main conclusion, however, is that **there is still a lot of work to do for the companies in consumer space**. The high ranking performers in our Index are likely to continue to put sustainability at the core of their strategy and to show improvement in the future.

The problem is that, although a lot of progress has been made, there are still several large companies with unclear sustainability strategies and poor disclosure performance. Our analysis clearly shows that some businesses, especially the ones that are based on bricks and mortar, appear to be struggling to adapt and are finding it difficult to develop their strategy around sustainability.

We hope you found the Circklo Sustainability Index interesting and useful. If you have any comments or suggestions, please send them to info@circklo.com.

Image courtesy of L'Oréal

Appendix

Rank	Company	Circular Integration	Financial Performance	Digital Acceleration	Circklo Sustainability Index
1	L'Oreal SA	65.6	54.4	80.0	**66.6**
2	Industria de Diseno Textil SA	59.6	54.1	82.5	**64.8**
3	NIKE Inc	60.4	46.4	82.5	**62.8**
4	LVMH Moet Hennessy Louis Vuitton SE	63.4	49.3	72.5	**61.9**
5	Hermes International	57.9	61.7	65.0	**61.2**
6	Henkel AG & Co KGaA	64.2	42.2	65.0	**57.9**
7	Amazon.com Inc	42.1	44.4	90.0	**57.1**
8	adidas AG	57.6	45.3	65.0	**56.1**
9	Nestle SA	53.2	37.7	77.5	**55.8**
10	Danone SA	62.8	30.3	67.5	**54.5**
11	Christian Dior SE	58.5	48.4	55.0	**54.4**
12	Diageo PLC	67.8	42.0	45.0	**53.2**
13	Cie Financiere Richemont SA	59.3	47.1	50.0	**52.8**
14	Heineken NV	55.9	22.8	77.5	**52.5**
15	Unilever NV	62.4	35.0	55.0	**51.9**
16	Keurig Dr Pepper Inc	48.1	35.3	72.5	**51.6**
17	Estee Lauder Cos Inc/The	62.4	51.9	35.0	**51.0**
18	Home Depot Inc/The	43.8	38.1	72.5	**50.7**
19	Coca-Cola Co/The	51.7	32.6	65.0	**50.0**
20	CVS Health Corp	58.7	20.0	65.0	**49.0**
21	McDonald's Corp	41.6	29.1	77.5	**48.6**
22	TJX Cos Inc/The	55.6	42.9	45.0	**48.6**
23	Colgate-Palmolive Co	62.1	42.2	35.0	**48.0**
24	Anheuser-Busch InBev SA/NV	52.7	28.1	57.5	**46.8**
25	Procter & Gamble Co/The	52.1	29.9	55.0	**46.3**

Appendix cont.

Rank	Company	Circular Integration	Financial Performance	Digital Acceleration	Circklo Sustainability Index
26	Starbucks Corp	50.2	35.2	50.0	**45.6**
27	UnitedHealth Group Inc	50.8	36.5	47.5	**45.5**
28	Cigna Corp	54.4	54.1	25.0	**45.5**
29	Lowe's Cos Inc	50.2	29.6	55.0	**45.5**
30	Humana Inc	52.8	40.4	40.0	**45.2**
31	Target Corp	63.0	28.9	35.0	**44.4**
32	Mondelez International Inc	53.8	23.6	50.0	**43.6**
33	Reckitt Benckiser Group PLC	52.1	35.4	40.0	**43.5**
34	Anthem Inc	53.3	35.2	37.5	**43.1**
35	Altria Group Inc	53.5	49.7	22.5	**43.1**
36	Philip Morris International Inc	48.8	46.0	30.0	**42.3**
37	Walmart Inc	45.4	31.5	47.5	**41.8**
38	Walgreens Boots Alliance Inc	54.0	30.4	35.0	**41.2**
39	Monster Beverage Corp	32.8	63.0	30.0	**41.0**
40	PepsiCo Inc	54.0	34.6	30.0	**41.0**
41	Costco Wholesale Corp	42.0	35.7	40.0	**39.5**
42	Marriott International Inc/MD	46.7	16.4	50.0	**38.6**
43	British American Tobacco PLC	48.5	47.3	10.0	**36.6**
44	Dollar General Corp	33.3	38.3	35.0	**35.3**
45	Las Vegas Sands Corp	49.1	36.9	10.0	**33.7**
46	Ross Stores Inc	36.5	45.6	15.0	**32.8**
47	Kimberly-Clark Corp	51.2	30.5	10.0	**32.6**
48	Alimentation Couche-Tard Inc	21.8	32.9	45.0	**32.1**
49	Centene Corp	21.9	33.7	35.0	**29.4**
50	HCA Healthcare Inc	24.3	20.8	5.0	**17.4**

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