EMBRACING SUSTAINABILITY

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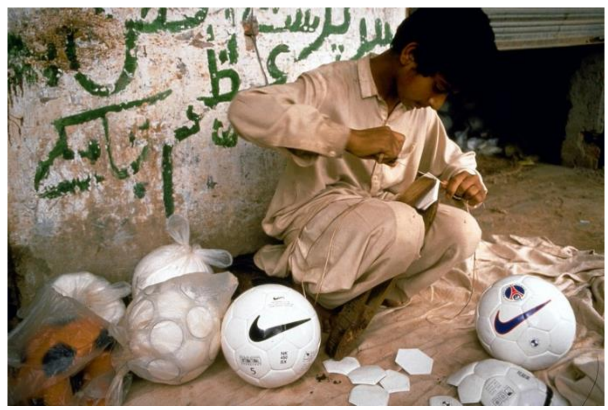
"The Nike product has become synonymous with slave wages, forced overtime and arbitrary abuse."

—Phil Knight, then-Chairman & CEO of Nike, 1998



Source: Life Magazine.

In the late 1990s, Nike's brand image had become increasingly tarnished due to a wave of environmental and safety scandals, with each scandal more painful than the next. In 1996, *Life* magazine published the shameful picture to the right, in which a 12-year old Pakistani boy was immortalized by stitching soccer balls for Nike in seemingly terrible working conditions. Subsequently, in 1997, an internal Nike-commissioned report published by Ernst & Young was leaked; this ghastly report highlighted that 77% of workers at a certain Nike supplier were experiencing respiratory problems and were exposed to carcinogens hundreds of times above the legal level.

Nike's response? Initially, denial, confusion, and apathy were the company's first lines of defense. Over time, the company's string of successive scandals began to hurt Nike's brand equity, pressuring company revenues and profits. Eventually, Nike was forced to address key sustainability questions, but only after its brand had become synonymous with sweatshop labor and environmental mismanagement.

Phil Knight and the Nike management team had finally come to grips with the fact that sound sustainability practices were merely a subset of sound management practices. Gradually but intentionally, management pivoted the company towards a more sustainable and responsible direction. Nike embraced sustainability in three important ways:

1) <u>Commitment to transparency</u>.
   By 2004, Nike made its supplier list, which was a key source of competitive advantage at the time, freely available to the public. This data allowed people looking for environmental and safety issues at factories to communicate directly with Nike about any problematic labor and/or environmental data that they may have uncovered.

2) <u>Reach out to industry stakeholders</u>.
   Nike co-founded the Fair Labor Association to track working conditions at factories that manufacture products for multiple customers.

3) <u>Sustainability link to innovation</u>.
   Nike stopped thinking of sustainability as a cost center and started viewing it as a way to catalyze innovation.

Over time, the scope of Nike's sustainability programs spanned across the organization. Today, Nike uses sustainability policies and procedures as a key competitive advantage to limit risks associated with environment, safety, and regulation. Nike is now generally viewed as a company that takes sustainability issues seriously; the company's performance in managing its Environmental, Social and Corporate Governance (ESG) risks consistently exceeds that of its industry peers.

Appleseed Capital's ESG Approach
At Appleseed Capital, we are long-term ESG investors. For us, enduring shareholder value is created by responsible management teams and prudent long-range planning. As part of our investment process, we examine ESG factors when we evaluate investments, when we communicate with management, and when we vote on shareholder initiatives. In our view, it is the right thing to do from a social and environmental perspective, but we have also found from our own experience that it can also be a rewarding and profitable endeavor.

As risk managers, we are always looking for useful tools which can help us identify, mitigate, or avoid investment risk. By examining ESG factors, we seed to avoid some of the investment risks related to environmental, social, and governance issues, which, in turn, should reduce idiosyncratic business risk.

Examples include:

- When a company focuses on improving its safety performance, it reduces the risk of a safety-related lawsuit.
- When a management team is aggressively looking to improve environmental performance, the likelihood of a large environmental-related liability diminishes.
- When management incentives are properly aligned with shareholders, managers are less likely to risk a company's competitive positioning for a short-term gain of its stock price.

With lessened investment risk, the probability of making money from a particular investment, in turn, should increase.

Appleseed Capital
Environmental, Social, and Governance Factors

Environment	Social	Governance
➢ Environmental policy ➢ Recycling policy ➢ Water management ➢ Sustainable transport ➢ Waste ➢ Climate change ➢ Sustainability best practice	➢ Health & safety ➢ Product safety ➢ Labor relations ➢ Community & stakeholder relations ➢ Consumer rights ➢ Supply chain management	➢ Business ethics ➢ Board structure ➢ Independent directors ➢ Chairman/CEO split ➢ Executive compensation and incentive structures ➢ Shareholder rights ➢ Conflicts of interest

When we analyze a company's ESG performance, we often ask ourselves the important question: "Is past performance an indicator of future performance?"

Transforming from Weak to Strong Sustainability Performance

In the case of Nike, there was a period of time when consumers were picketing Nike stores and investor sentiment with regards to Nike, including ESG investor sentiment, was tepid at best. The company even ceased reporting on social responsibility for a time because it was engaged in a problematic shareholder lawsuit.

At what point should Nike have become investable for ESG investors? What if management is quick to make important changes to its ESG policies? What if management seems uninterested in making important changes? At the end of the day, it simply is not possible to erase Nike's history; rather, it was only possible to allow recent history to fade away.

Nevertheless, after it became clear that a cultural inflection point was afoot at Nike, investors should have been rewarding Nike for its meaningful embrace of sustainability – especially its state-of-the art policies and procedures which were being used to manage ESG risks. Determining these inflection points is a difficult task for investors, but we believe that identifying important inflection points should lead to investment alpha.

In our view, dramatic improvements in ESG policies, procedures, and transparent goals tied to sustainability outcomes are important indicators for assessing future sustainability performance. Similarly, significant sustainability-driven innovations are important indicators.

Disciplined ESG investing is about finding attractive investment opportunities in companies that embrace sustainability as part and parcel of their core businesses. Looking merely at historical ESG performance data and disclosures, however, is insufficient. After all, as investors, we are in the business of looking forward, managing potential future risks, and taking advantage of future opportunities.

In this analysis, we examine two Appleseed portfolio companies, Titan International and Herbalife, to illustrate why forward-looking ESG analysis matters to us as investors. Titan has been making wide-ranging ESG innovations in its core business, while Herbalife has implemented greatly enhanced ESG-related policies and procedures that should positively impact them, their customers, their workers, and other stakeholders for years to come.

Titan International

Headquartered in Quincy, IL, Titan International (NYSE: TWI) is a leading global producer of wheels and tires for off-highway purposes; their products are ultimately sold into the agricultural, earthmoving, construction, and specialty wheel & tire markets for both OEM and aftermarket purposes. Historical corporate governance has not been stellar, and we are not fans of the former CEO. As a shareholder advocate concerned about Titan's corporate governance, we filed successful shareholder resolutions in 2016 and 2017 which addressed board diversity and the separation between the Chairman and CEO roles.

Importantly, over the past few years, key management changes have taken place within Titan, and we think the company is headed in a new trajectory of improved ESG performance and, relatedly, improved operational performance. For example, in recent years, Titan has aggressively developed two unique and disruptive businesses that could well be transformative, environmentally friendly, and highly value generative.

Polluting local environments, unsightly used off-highway tires can be found in remote locales across the world; equipment users often times are unable to find a sensible way to recycle or dispose of these tires. For years, it made little economic sense to address this environmental issue, so off-highway tire users simply discarded these giant tires off to the side of their respective facilities. However, Titan recently started a new business unit called the Titan Tire Reclamation Corporation (TTRC), which kicked off operations in April of 2016. Through a pyrolysis process, Titan is reducing these used tires to their core inputs of steel, carbon black, and rubber, and then reselling the reclaimed inputs. This recycling process improves the carbon footprint for such tires and generates material carbon credits. Shockingly enough, Titan has publicly claimed that they should be able to generate higher EBITDA margins with TTRC at full utilization rates than they are able to achieve in the original manufacturing of such tires.

Source: Shomnath.com.

Separate from the company's TTRC innovation, Titan recently launched a Low Sidewall (LSW) tire/wheel assembly product set that features a larger rim diameter and smaller sidewall than comparable standard off-highway tires; overall, LSW provides greater equipment stability and increased productivity for agricultural usages. The bouncing of a tractor associated with high draw bar applications is reduced, leading to higher levels of fuel efficiency and less maintenance. Road lope (the physical swaying and bouncing of an off-highway machine during road transport) is improved through the usage of LSW, thus allowing operators to drive these vehicles faster between fields. Furthermore, soil compaction, which can cause smaller yields and lower quality plants, is reduced in fields that are farmed using LSW wheelsets. In summary, this innovation could very well revolutionize the off-highway wheel & tire industry, and Titan stands at the forefront of this sustainability initiative.

Titan clearly is creating important innovations tied to sustainability, and it is investing heavily to find ways to lessen environmental impact. We view these ESG-related innovations, along with important changes in the management team during the past few years, as indicative of an important inflection point with regards to ESG performance.

Herbalife

Herbalife Ltd. (NYSE: HLF) is a leading nutritional company that offers weight management products, nutritional supplements, and personal care products – all of which are intended to support a healthy life style. Their products are sold through a multi-level marketing (MLM) system. In our view, Herbalife does a lot of social good by providing jobs for would-be entrepreneurs and helping people lose weight, reduce the risk of contracting diabetes, and improve their general health.

At the end of 2012, famed hedge fund investor Bill Ackman publicly disclosed a massive short position in Herbalife; he alleged that Herbalife was an illegal pyramid scheme that was taking advantage of its customers and distributors. With his deep pockets, an army of lobbyists, and a small brigade of public relations professionals, Ackman succeeded in convincing the U.S. Federal Trade Commission (FTC) to commence an investigation of Herbalife's business practices.

In July 2016, the FTC closed its investigation on Herbalife by handing the company a $200 million settlement fine, but without declaring Herbalife to be a pyramid scheme. According to management, Herbalife settled with the FTC because the financial cost and distraction of protracted litigation would have been overly burdensome. The FTC stated that they planned to use the settlement money to send checks to people who had lost money as a Herbalife distributor.

Because of Ackman's allegations and the related FTC investigation, Herbalife is currently viewed poorly by some ESG investors, and incorrectly so. In our view, Herbalife is not a pyramid scheme; it is a company doing very good things for its distributors and consumers. We have performed enormous due diligence on Herbalife, visiting stores, talking with customers, and reviewing data, and, through this due diligence, we have come to several important conclusions which are very much still non-consensus views.

First, the products are bought by the company's customers for consumption purposes. If the company was a pyramid scheme, the company would have already collapsed as it implemented the FTC's new compensation rules.

Second, the product helps people transition to a healthier lifestyle; its products and its nutrition clubs have enabled material health improvements among many of its long-term customers. We have seen countless before-and-after pictures from faithful customers we have met at surprise visits to Herbalife locations.

Third, the MLM model is not only not a problem; it is a critical *strategic asset* which enables the company to better deliver its unique value proposition to its customers. The MLM network, in effect, serves as an important support network for Herbalife consumers who are trying to change their dietary habits.

Fourth, Ackman's allegations have become an important catalyst for cultural change; Herbalife has made dramatic improvements to its distributor and consumer related policies and procedures that enhance transparency and should help management reduce ESG related risks going forward. In our view, Herbalife is a best-in-class for its industry from an ESG perspective; furthermore, management seems intent on steering clear of corporate governance issues which could put it in the crosshairs of the FTC and any other regulators again.

Unsurprisingly to us, a fascinating revelation has emerged after the FTC began mailing checks to Herbalife distributors in January 2017. *Fortune* magazine wrote in February 2017:

> *"But now that almost 350,000 checks have been mailed, a curious pattern has begun to emerge: Many of the people receiving money from the FTC don't appear to be victims at all. In fact, of those who received the checks, the largest of which are more than $9,000, many are actually happy customers who still use the meal supplements. Some still work for Herbalife. Even members of the company's president's team, a special status that confers a larger product discount on high-volume distributors, have received a cut of the FTC settlement. What's more, some check recipients say they plan to "flip" their settlement payout, i.e. use the money to buy more products from Herbalife."*

We believe Herbalife is a strong ESG performer, a best-in-class company, and likely to generate strong long-term returns for Appleseed investors.

At Appleseed Capital, we search for investment opportunities in high quality companies where management is thinking proactively about managing ESG risks. Ideal prospective companies perform better than their peers with regards to corporate responsibility. We also look for responsible management teams that focus on building long-term, enduring stakeholder value for its stakeholders.

Importantly, examining historical controversies and ESG disclosures alone may not be sufficient to generate ESG-related alpha. By focusing only on historical controversies and negative headlines, investors might miss an opportunity without conducting an independent assessment of future ESG performance. In our view, it is important to take a holistic approach in examining ESG factors.

Diligent bottom-up forward-looking ESG analysis while looking for important indicators of inflection with regards to a sustainability culture. For Appleseed Capital, what matters most to us is 1) the nature of the business, 2) management's commitment to ESG principles, and 3) the policies, procedures, and outcome-based goals that management teams implement to mitigate future potential ESG risks and take advantage of ESG opportunities.

Disclosure

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