

Fortune Brands

Engagement commentary



Federated Hermes SDG Engagement Equity Fund
Q2 2021

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Hermes** 
International

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ENGAGEMENT COMMENTARY:

Fortune Brands

Fortune Brands Home & Security offers industry-leading, innovative brands for kitchens, bathrooms, entryways, and outdoor living spaces. The company is headquartered in Illinois, US, and has 86 manufacturing plants and distribution centres worldwide. Over 80% of revenue is generated within the US.

Market capitalisation:

\$14.2bn 

Revenue:

\$6.1m 

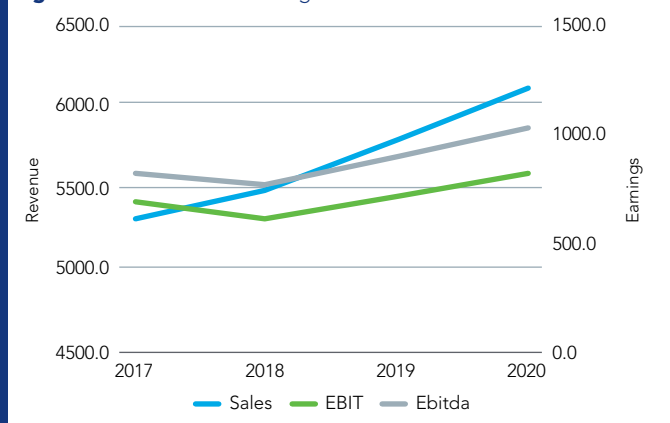
Number of employees:

27,500 
of which 38% are female

Headline progress

- The company's primary bathroom brand, Moen, has committed to saving 1tn gallons of water by 2030 – equivalent to 40m swimming pools or 24bn baths.
- We calculate that, over the period 2018-2020, via its bathroom faucet and showerhead sales, the company has saved 5.6bn gallons of water (21m M3). Its water savings per annum have increased 28% over that period.

Figure 1. Revenue and earnings over time

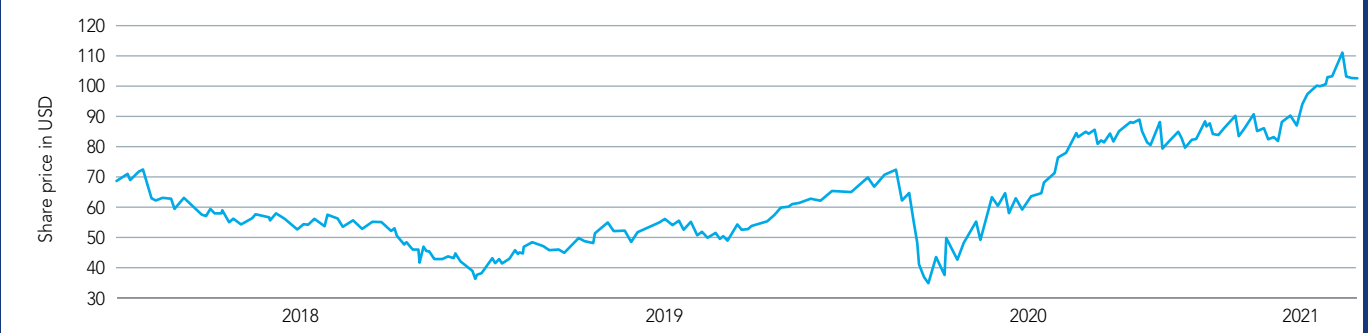


Source: Fortune Brands, 31 December 2020.

Investment case

- Leading market shares in several home products with strong competitive positioning.
- Cyclical exposure to improving US housing market, which has structural under supply of housing.
- Well managed and governed company with an extended track record of execution, along with a strong balance sheet and free cashflow generation.

Figure 2. Fortune Brands Home & Security - US equity price



Source: Bloomberg, June 2021.

Theory of change

Our impact thesis is threefold:

1. Sustainable sourcing

The principal raw materials used in the company's cabinets business are hardwoods (maple, birch and oak), plywood and particleboard. Logging in violation of national laws accounts for 8-10% of global production and trade in forest products. It also represents 40-50% of all logging in some of the most valuable and threatened forests on earth.¹ Halting deforestation is critical to achieving the Paris Agreement and the Sustainable Development Goals – all pathways considered by the Intergovernmental Panel on Climate Change (IPCC) assume both a halt in deforestation and significant reforestation.

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Forests around the world are accessed to supply furniture, flooring, lumber, and other building materials to the booming global marketplace. As a large manufacturer, the company has the ability to use its influence over suppliers to create a positive impact. A sustainable supply chain and good relationships with suppliers is crucial to its ability to deliver products to customers. To that end, ensuring that all timber is sourced from Forest Stewardship Council (FSC) or the Programme for the Endorsement of Forest Certification (PEFC) certified sources, with full chain of custody through the supply chain, offers the opportunity to ensure that deforestation risks are mitigated and opportunities for generating a positive impact on biodiversity and reforestation are grasped.

2. Resource efficient manufacturing

By investing in, and reducing, the environmental impact of its operations, the company has the ability to generate an increasingly net positive contribution towards climate change mitigation.

3. Eco-efficient products

The average American family uses more than 300 gallons of water per day at home. Roughly 70% of this use occurs indoors. Of this, 24% is attributed to toilet use, 20% shower use and 19% taps.² Water scarcity is a growing issue in many regions, including in the US where a number of communities are beginning to face supply challenges. A US Government Accountability Office report from 2014³ showed that 40 out of 50 state water managers expected water shortages in some portion of their states over the next decade. To state the obvious, the less water we are able to use in the home, the less strain is put on reservoirs, and the more water available in lakes, rivers and streams.

Fortune Brands, as a leading manufacturer of home plumbing needs, has the ability to support more water efficient practices within homes and in so doing avoids unnecessary water usage.

Practice of change

Over the period of our investment, we have met extensively with management to discuss issues of interest and have been encouraged by the progress made. While there remains scope for further progress, the company has delivered meaningful improvements in practices already. Notably its ESG disclosures go significantly further than those provided by its principal domestic peers and is catching up with that of its international competitors.

1. Sustainable sourcing

Wood is the main component of Fortune's cabinet products. Positively, wood is renewable, recyclable and durable. Being a sustainable choice, however, requires that it comes from sustainable forestry.

Several organisations across the world dedicate their efforts to creating a system for maintaining and monitoring sustainable wood. The most rigorous of these is considered to be that run by the FSC, formed in 1993 after the previous year's Rio Earth Summit. It has evolved a robust certification system, which is internationally recognised and has become accepted as a way to ensure the use of sustainable woods.

¹Timber | Industries | WWF (worldwildlife.org).

²Water Research Foundation, Residential End Uses of Water, 2016.

³Freshwater: Supply Concerns Continue, and Uncertainties Complicate Planning (gao.gov).

Today, more than 550 million acres of forest are certified under FSC's system, including nearly 155 million acres in the US and Canada.⁴ As of 2020 however, less than 20% of wood materials sold in the US is FSC certified.⁵

In the case of Fortune Brands, 70% of its timber sourcing is from North America with the remainder from Brazil and Asia. In recent years, the company has pivoted its supply chain away from China and, in 2020, reiterated its commitment to wood supply chain management. The company contends that it meets or exceeds the standards of the Lacey Act, which prohibits importing, purchasing, or acquiring products made from illegally logged woods. Furthermore, the company suggests that it gives preference to suppliers who participate in FSC or other certification programmes.

In addition, the vertically integrated manufacturing of the company's Fiberon-recycled composite deck boards is an illustration of its commitment to maximising resource efficiency. Waste wood generated from the company's cabinet production is captured and directed towards input material for their decking boards. As a result, the deck boards are 94%+ comprised of recycled material.

As a result of this recycled wood input, the company claims it has prevented 1m trees from being cut down.⁶



There has been debate and scepticism expressed about the value and impact of timber certification. To that end it is interesting to consider the potential offered by blockchain with respect to material traceability. Like many global supply chains, forest-related supply chains rely on paper documentation, including a paper trail of invoices. Paper systems open the potential for fraudulent claims by cause of tampering with or falsifying documentation to inflate material volumes. Blockchain can fundamentally change how compliance and traceability of FSC materials across supply chains are verified using secure technology, breaking free of paper-based documentation.

We welcome the commitments that Fortune Brands has made, and its efforts with respect to maximising resource efficiency. Nonetheless, we continue to encourage the company to go a step further and formalise a commitment to sustainably certified wood sourcing with full chain of custody assurance so that the risk of exacerbating deforestation is mitigated further. A step further still would be to consider whether it can go beyond mitigating harm to being net positive.

There has been increased focus on this topic in recent years, not least given the heightened appreciation of its impacts on biodiversity. This has been reflected in commitments towards deforestation-free timber being made by over 80 retailers⁷ – said retailers have usually also opted to work with their suppliers to absorb any added costs. One of the most ambitious, and thus lauded, commitments has been from Kingfisher to work towards global net reforestation.

Examples of best practice globally include:

- **Kingfisher** – this British multinational retailer requires FSC certification with full chain of custody through the supply chain and is committed to becoming forest positive by 2025 – this means supporting reforestation programmes which will create more forest than they use.
- **Nobia** – the Swedish kitchen cabinets manufacturer is committed to 100% of its cabinets in the UK being FSC certified with full traceability to the customer by 2021 (80% was certified as of FY20).

2. Resource efficient manufacturing

While less progress has been made to date, it is clear that the company has recognised the need to do more. Indeed, in the company's 2020 ESG report, it explicitly acknowledged that climate change needs to be quickly and comprehensively addressed, and it is committed to being part of the solution.

During 2021, the company is reviewing the Task-Force on Climate-related Financial Disclosures (TCFD), evaluating renewable energy opportunities and creating a carbon mitigation strategy. Further to this, the company has also noted that it will be setting carbon-related targets and making those commitments public.

With 2021 set to be a pivotal year in the race to re-align global economies, this commitment is welcome. We have previously made introductions to organisations such as RE100 – a global initiative bringing together the world's most influential businesses committed to 100% renewable electricity – and we look forward to discussing the detail of the company's carbon mitigation strategy later in the year.

3. Eco-efficient products

One of the growth engines of the business in recent years has been the growth of its plumbing business. As of the end of FY20, plumbing represented 36.2% of revenue and 51.7% of income.

In 2015, due to the severity of California's drought, the governor signed an executive order in April 2015, authorising the California Energy Commission to launch new water-saving standards for appliances with immediate effect. This order lowered the permitted water flow-rates for both bathroom and kitchen faucets and had a very short grace period. As a result, many companies – Fortune not exempted – had to embark on rapid innovations and product adaptations.

Roll forward to 2021 and the company is now very much ahead of competitors and indeed ahead of regulation. The company's plumbing group has a strong commitment to innovation and water savings.

- The company's primary bathroom brand, Moen, has committed to saving 1 trillion gallons of water – equivalent of the average annual household water use of more than 11m homes,⁸ 40 million swimming pool and 24 billion baths.⁹

As of our last dialogue with the company in May 2021, the company's bathroom products are now predominantly WaterSense labelled with a clear step-up in the period since 2018.

⁴What We Do (fsc.org).

⁵What Is Sustainable Wood? | Hunker.

⁶Fortune Brands 2020 ESG report, p20.

⁷WWF Business Case responsible sourcing_0.pdf.

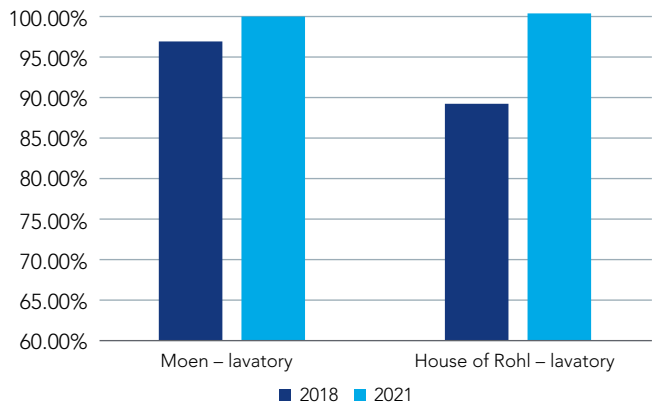
⁸Leak Facts | WaterSense | US EPA.

⁹USA TODAY — Shout-out to University of Georgia geography and... (tumblr.com).

WaterSense labelled products meet EPA specifications for water efficiency and performance, and are backed by independent, third-party certification. Products bearing the WaterSense label:

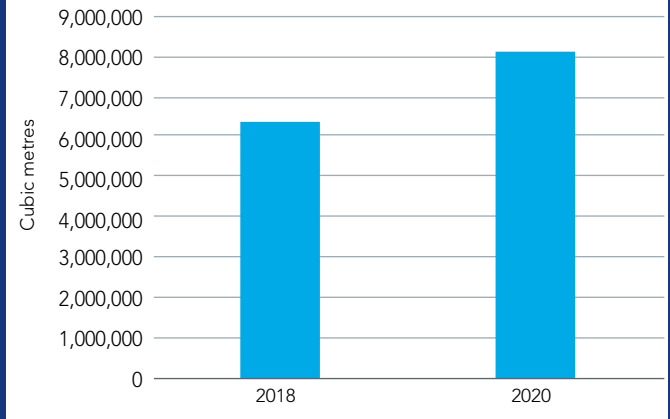
- Perform as well or better than their less efficient counterparts and are 20% more water efficient than average products in that category.
- The average family could save 2,700 gallons of water per year by installing WaterSense labelled showerheads.
- By replacing old, inefficient toilets with WaterSense labelled models, the average family can reduce water used for toilets by 20-60%.
- Replacing old, inefficient faucets and aerators with WaterSense labelled models can save the average family 700 gallons of water per year.

Figure 3. % WaterSense labelled lavatory products



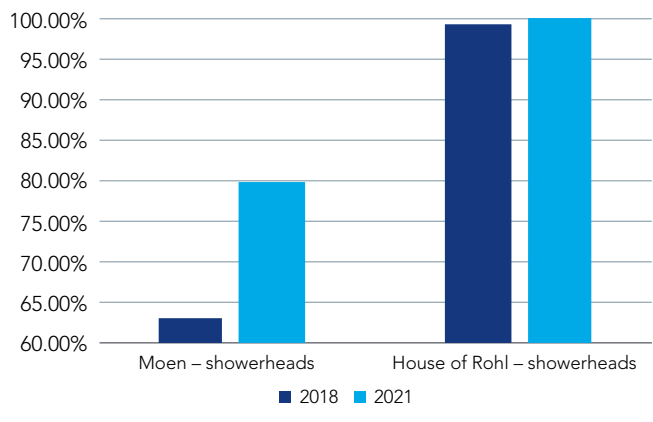
Source: Fortune Brands - Global Plumbing Group.

Figure 5. Cubic metres (M3) water saved



Source: Fortune Brands - Global Plumbing Group.

Figure 4. % WaterSense labelled showerhead products



Source: Fortune Brands - Global Plumbing Group.

With respect to their kitchen products (where WaterSense labelling is not available), as of 2021, the company has adapted all products to deliver a 1.5 g/pm flow rate. This compares favourably against the market where their internal analysis suggests that just 10-20% of the market are at that lower flow rate today.

We calculate that over the period 2018-2020, via its bathroom faucet and showerhead sales, the company has saved 5.6b gallons of water (21m cubic meters (M3)). More impressively, its water savings per annum have increased 28% over that period.¹⁰

In addition to the water savings being achieved via the aforementioned product sales, the company has launched other innovations such as its Nebia spa-like shower that uses half the water of a conventional shower. Since 2015, when the first Nebia Spa Shower was launched, more than 100m gallons of water have been saved according to the company. Furthermore, its other technologies such as U by Moen help owners save water through smart controls, and Flo by Moen is a whole-house water leak prevention and detection system. A study has shown that Flo by Moen can decrease water leak claims by 96%.¹¹

We calculate that over the period 2018-2020, via its bathroom faucet and showerhead sales, the company has saved

5.6b gallons of water (21m M3).



Other

We were pleased to see the move to an independent chair at the beginning of 2021 with Susan Kilsby, an experienced director with concurrent roles at BHP, Diageo and Unilever (Susan is stepping down from BHP in 2021). Susan replaces former CEO Chris Klein who had continued to perform the role of chair having stepped down as CEO in January 2020.

Since 2015, when the first Nebia Spa Shower was launched, more than 100m gallons of water have been saved

¹⁰The above calculations are based on our estimates for the number of units sold and informed by our understanding of the proportion of said units that are WaterSense labelled (based on the company's Global Plumbing Group sales being 70% from bathroom products (lavatory, showers and faucets) and 30% kitchen.

¹¹ LexisNexis IoT white paper | LexisNexis Risk Solutions.

Engagement timeline

Closed objectives

1. Eco-efficient products – closed May 2021

- Further to Moen's commitment to saving 1tr gallons of water by 2030, we were pleased to note that the company has adapted all of its kitchen faucets to a lower flow rate of 1.5 gallons per minute. In so doing, it is taking a leadership position in the industry.

2. Sustainability reporting – closed June 2019

- The company published an inaugural sustainability report which we were reassured was very much a first iteration. Further progress has been made and its disclosures outstrip domestic peers.

Open objectives

- Sustainable sourcing – M3** – objective is to encourage the company to establish a sustainable timber policy with targets for certified wood sourcing and recycled timber (and aspire towards a restorative approach).

- Carbon neutral production – M4** – objective is for the company to measure and report on its scope 1 and 2 emissions, establish forward-looking targets to move towards carbon neutral operations and ultimately set net zero commitments.

Milestone 1 Initiate dialogue

Milestone 2 Issue validated

Milestone 3 Plan developed

Milestone 4 Plan implemented

We write to the chair to introduce the Fund and our objectives.

We write to the CEO on the topic of working conditions. We emphasise that the right long-term approach could be more cost-effective, while also increasing output, enhancing corporate reputation, and benefiting society.

We are encouraged by the news that more sustainability-orientated questions are being put to the business by the company's board. This reflects a change of mandate for the Nominations Committee, whose remit expanded to include environmental, social and governance (ESG) matters earlier in the year.



Next steps

We will continue to engage with Fortune Brands on the issues outlined in this note. We hope to see further progress made on its sustainable sourcing practices and climate mitigation strategy. Most fundamentally, we are hopeful that it will continue to take a leadership position within the industry with respect to water-efficient home plumbing products, further scaling its impact and gaining market share too.



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Federated Hermes

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