January 26, 2017

Dear Board Member:

We at State Street Global Advisors (SSGA) have the privilege of managing over $2.4 trillion in assets.* As fiduciaries and active stewards, we represent the interests of our clients, who are the actual owners of these assets that we manage. And, as long-term investors acting on our clients’ behalf, we focus on maximizing the probability of achieving attractive returns over the long run, so that our clients can meet their investment goals, whether it is saving for retirement, funding research and innovation or building the infrastructure of tomorrow. That mission drives our engagement with our portfolio companies such as yours and our commitment to sharing our views as stewards of our clients on risks and opportunities that we believe affect long-term value creation.

ESG and Long-Term Value Creation

Ahead of the upcoming proxy season, I want to provide our latest perspectives on how we believe boards can effectively work with management to incorporate a sustainability lens into long-term company strategy. We define sustainability as encompassing a broad range of environmental, social and governance (ESG) issues that include, for example, effective independent board leadership and board composition, diversity and talent development, safety issues, and climate change. Over the long term, these issues can have a material impact on a company’s ability to generate returns. As one of the largest index managers in the world, our size, global scale and long-term ownership provide a unique, top-down vantage point across industries and countries on the ESG risks and opportunities confronting companies and their shareholders.

Each year our asset stewardship team identifies specific areas that may impact value over the long term and issues guidance to our portfolio companies on how we think about addressing those areas, and what our expectations around their actions will be. Active, transparent engagement, rather than passive inaction or adversarial interaction, is the hallmark of our approach. Through this patient and consistent engagement, using both our voice and our vote, we track the progress we make on promoting positive change.

We have engaged with companies across a full range of ESG issues for many years. Our overarching focus has been on ensuring effective, independent board leadership, which we believe is the threshold requirement for long-term value creation. A strong, effective board, committed to the long term and independent of management, is far more likely to lead to attractive results than any particular guidance or rules that we or others may promulgate. Since we have already issued extensive guidance on this governance area, in 2017 we will be increasingly focused on board oversight of environmental and social sustainability in areas such as climate change, water management, supply chain management, safety issues, workplace diversity and talent development, some or all of which may impact long-term value. While none of us can state definitively “the answer” for a particular company, and we acknowledge that certain industries will face different issues, we believe that over time these areas can pose both risks to and opportunities for long-term returns. Therefore, as stewards we are convinced that addressing ESG issues is a good business practice and must be part of effective board leadership and oversight of long-term strategy. Corporate scandals of the last few years, such as those around automotive emissions, food safety or labor issues emphasize the need for companies to assess the impact of ESG risks. But environmental and social issues can also affect value creation in positive ways, and our attached ESG guidance framework includes examples of companies that are proactively using these ESG considerations to drive growth and innovation for the future.
Focus on Climate Change Risk
Increasingly boards have asked us for guidance on how they might incorporate a sustainability lens into their long-term strategy. This was especially true after our votes in 2016 in which we supported shareholder resolutions on climate change initiatives that set us apart in the industry.

Since 2014, climate change has been a priority engagement issue for us because of its potential to impact long-term results. Last year we created a framework to help boards capture and evaluate different kinds of physical, regulatory and economic risks associated with climate change within specific sectors. We have provided detailed guidance as to how we assess a company’s evaluation of climate risk and its preparedness for addressing it. We have also sought to ensure that our voting record aligns with the priorities we have communicated to our portfolio companies. While we make case-by-case decisions when voting proxies, we will support climate resolutions if companies’ disclosure, practices and board governance structures are found to be inadequate. That was the rationale behind our votes in 2016.

Helping Boards Focus on ESG Impacts
In the attached framework, you will see that, as part of our stewardship review, we classify companies according to how they have: 1) identified material environmental and social sustainability issues; 2) assessed and, where necessary, incorporated the implications into their long-term strategy; and 3) clearly communicated their approach to sustainability and its influence on strategy. We also include a list of questions that boards can use as a starting point to begin to work with management to focus on ESG issues.

As one of the largest asset managers in the world, we have an important responsibility to the millions of individuals who entrust their financial futures to us through retirement plans, endowments and foundations, financial intermediaries, and sovereign institutions. Our mission is to invest responsibly on their behalf to enable economic prosperity and social progress over the long term. We believe that a focus on ESG issues is a critical requirement for us to deliver against that mission. At the same time, we recognize that companies through sound management and effective, independent board oversight are in the best position to determine what will create long-term value for shareholders. Therefore, as always our focus will be on process and approach rather than rules and “litmus tests.”

We look forward to working together with you.

*Assets under management were $2.4 trillion as of September 30, 2016. AUM reflects approximately $40.29 billion (as of September 30, 2016) with respect to which State Street Global Markets, LLC (SSGM) serves as marketing agent; SSGM and State Street Global Advisors are affiliated.

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Summary

• State Street Global Advisors’ (SSGA) asset stewardship program is aimed at engaging with our portfolio companies on issues that impact long-term value creation across environmental, social and governance (ESG) considerations.

• In the recent past, SSGA has issued extensive guidance on key governance matters such as effective, independent board leadership. SSGA’s current focus is on helping boards think about the possible impacts of environmental and social issues and incorporating a sustainability lens into boards’ oversight of long-term strategy as a sound business practice.

• Our framework for evaluating companies is based on each company’s approach to sustainability, drawing upon our past engagements with many companies on these issues.

• This framework reviews and categorizes a company’s approach to sustainability according to three criteria:
  – Has the company identified material environmental and social sustainability issues relevant to its business?
  – Has the company assessed and, where necessary, incorporated the implications of relevant environmental and social sustainability issues into the company’s long-term strategy?
  – Has the company adequately communicated its approach to sustainability issues and its influence on strategy?

• We then classify companies according to which criteria they have met:
  – Tier One companies have satisfied all three criteria.
  – Tier Two companies typically have satisfied one or two criteria.
  – Tier Three companies have not considered sustainability issues at all.

• We believe boards can play an important role in strengthening a company’s approach to sustainability. Thus, we have provided a framework that is intended to help boards consider and communicate how these risks and opportunities affect long-term strategy.

Overview

Sustainability encompasses a broad range of environmental, social and governance (ESG) factors that include topics such as effective, independent board leadership and board composition, workplace diversity, safety and management of environmental impacts. Sustainability has been at the center of SSGA’s asset stewardship program for a number of years. SSGA has had approximately 2,200 engagements on ESG issues with over 1,200 companies in our global portfolio since 2013. While board governance has been a significant focus of our thought leadership efforts in the past, we have also been engaging with companies and developing our views on environmental and social considerations and their effect on our stewardship obligations. We acknowledge that sustainability issues differ by industry and do not impact all companies equally. However, we are certain that over time these issues pose both risks to and opportunities for long-term returns. Therefore, as stewards we are convinced that, as part of good business practice, ESG issues must be part of effective board leadership and board oversight of long-term company strategy.

Since we have made our position on governance matters clear in the past, this paper focuses more specifically on board approaches to environmental and social sustainability issues.

SSGA’s Framework for Evaluating Sustainability Approaches

Engagements with portfolio companies are typically conducted on a multi-year basis. Initial engagements on sustainability focuses on company processes, practices and reporting/disclosure. Ultimately these engagements evolve into an assessment of whether the board has considered the impact of sustainability issues and how, if appropriate, these sustainability factors are linked to the company’s long-term business strategy. We evaluate companies according to a framework (see Figure 1) that we have developed based on numerous engagements with portfolio companies on their sustainability approaches.

Figure 1: SSGA’s Framework for Evaluating a Company’s Approach to Sustainability

<table>
<thead>
<tr>
<th>STEP 1</th>
<th>STEP 2</th>
<th>STEP 3</th>
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<tbody>
<tr>
<td>Has the company identified material environmental and social sustainability issues relevant to the business?</td>
<td>Has the company assessed and, where necessary, incorporated those issues into their long-term strategy?</td>
<td>Has the company communicated its approach to sustainability issues and the influence of these factors on strategy?</td>
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</table>
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We use this framework to categorize companies according to how comprehensively a company has considered sustainability risks and opportunities. Tier One companies have undertaken all three steps, while Tier Two companies have undertaken only one or two of these steps. Companies that have not undertaken any of these steps are categorized as Tier Three.

We believe that Tier One companies are positioning themselves for the long term, as these companies have successfully incorporated a sustainability lens into their strategic planning process around innovation, product development and capital allocation. These companies have developed a strategic perspective on sustainability that clearly supports the company’s business objectives, and the impact of sustainability considerations on long-term business decisions is clearly articulated.

In contrast, we have found that Tier Two companies may have well-developed, standalone sustainability programs, but these programs are often not integrated into their overarching business strategy. For example, while these companies may have identified material ESG factors, they may not have expressly incorporated them into the company’s strategy. Or a company may not clearly articulate for investors how these factors influence long-term strategic choices, or not provide relevant data on key performance indicators (KPIs) or not establish long-term goals that align with the strategy.

We believe returns at Tier Three companies are at the greatest risk in the long term, as management and boards fail to acknowledge and plan for business disruptions or opportunities related to sustainability issues.

Of the 177 companies in our global portfolio that we deeply evaluated in 2016 according to their approach to sustainability, we found that only 7% of companies qualified as Tier One; 72% of companies were classified as Tier Two; and 21% were in the Tier Three category.

Active Stewardship of Portfolio Companies

As an index investment provider, SSGA invests in Tier One, Tier Two and Tier Three companies. However, because we take a risk-based approach with our active stewardship program, we focus efforts on Tier Three companies that have disregarded sustainability issues or have failed to communicate their position on such issues to shareholders. When we believe that engagement alone is not effective, we will incorporate our assessment of a company’s approach to sustainability into our proxy voting decisions. As a result of these efforts, we have had a growing number of inquiries from our portfolio companies on how to improve their approach to sustainability issues.

Guidance for Directors on Incorporating Sustainability into Strategy

As long-horizon investors, we believe it is important for companies to assess the possible impacts of sustainability issues on strategy as a good business practice. We also believe that boards can play an important role in strengthening a company’s approach to sustainability and that it is for the board, as part of its oversight of strategy, to ensure that management consider, and communicate, how these issues affect long-term strategy, if at all.

We have developed a series of questions (see Figure 2) to help guide boards in undertaking this process.

In addition, we have also provided examples in Figure 3 of how some companies have addressed each one of these issues. These examples are not prescriptive; rather they are illustrations to help companies and boards develop their own approach to sustainability.

Figure 2: Addressing Sustainability Issues: Questions for Boards

1. Has the company identified the sustainability issues material to the business?
2. Has the company analyzed and incorporated sustainability issues, where relevant, into its long-term strategy?
3. Does the company consider long-term sustainability trends in capital allocation decisions?
4. Is the board equipped to adequately evaluate and oversee the sustainability aspects of the company’s long-term strategy?
5. Does the company’s reporting clearly articulate the influence of sustainability issues on strategy?
6. Is the board incorporating key sustainability drivers into performance evaluation and compensation programs?
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Figure 3: How Companies Have Sought to Address Sustainability Issues

Identifying sustainability issues material to the business
- Many companies conduct peer reviews to identify sustainability-related KPIs
- Some companies are adopting a more scientific approach to identifying materiality and prioritizing KPIs by using analytic tools to quantify environmental and social impacts
- KPIs are further managed using management information systems (MIS) or dedicated environmental management systems (EMS) which facilitate internal and public reporting
- Life-cycle assessments (LCAs) are an example of how companies can identify the environmental and social areas that are most impacted throughout a product’s life-cycle, from raw material extraction through end-of-life management. The information collected from LCAs can be supplemented with a company’s internal and external stakeholder engagements to prioritize impact areas by materiality

Analyzing and incorporating sustainability issues, where relevant, into long-term strategy
- At some companies, boards get regular updates on material sustainability matters or boards have dedicated sessions to discuss sustainability trends relevant to the industry and company
- Some companies have appointed a Chief Sustainability Officer to reflect the importance of sustainability issues to the company’s strategy

Including long-term sustainability trends into capital allocation decisions
- Some companies that have incorporated environmental and social factors into strategic planning and capital allocation decision-making processes have made early investments that have helped the company realize benefits through brand differentiation, introducing new lines of businesses, lowering the risk profile of the company, and improving access to capital
- For example, some companies have invested in clean-tech research that has led to the development and marketing of products that are eco-friendly and have a lower environmental impact than traditional products

Strengthening board oversight of sustainability practices
- To ensure that the board is actively engaged on emerging risks and opportunities as they relate to sustainability, some companies give their directors explicit oversight responsibility of sustainability practices by incorporating it into committee charters or governance guidelines or through a dedicated Corporate Responsibility Committee

Incorporating key sustainability drivers into performance evaluation and compensation programs
- While several companies include sustainability drivers in executive compensation programs, very few companies meaningfully communicate to investors the efficacy of achievements that justify compensation payouts
- Companies that effectively incorporate sustainability drivers into performance evaluation and compensation programs are good at:
  - Identifying sustainability matters that are material to the business
  - Have systems in place to quantify or measure performance related to material sustainability issues
  - Establish performance goals against which they measure achievement
  - Disclose to shareholders the material sustainability issues that drive compensation, the specific goals or performance targets that management has to achieve and report on the actual performance against established goals to justify compensation payouts

Communicating the influence of sustainability factors on strategy
- In their strategic narrative to investors and other stakeholders, Tier One companies communicate their approach to sustainability and the extent to which sustainability factors are integrated into or impact strategy. These companies include relevant information such as ESG KPIs in investor presentations
- Examples of Tier One companies that demonstrated the impact of sustainability issues on long-term strategy:
  - In response to obesity and public health concerns, a food and beverage company developed product lines that reduced fat and sodium content, giving customers healthier product options
  - An energy company invested in low-emission technologies and decommissioned aging carbon-intensive operations to create a more diversified energy portfolio in response to the board’s assessment of regulatory and investment/consumer trends pertaining to climate change
  - An international coffee company changed its sourcing guidelines to incentivize and reward farmers who use sustainable practices to make its supply chains more resilient, while ensuring consistency in the quality of its agricultural products
- Examples of Tier Two companies that did not fully communicate their sustainability narrative:
  - A services company that identified talent recruitment and employee retention as a material social issue, communicated the programs implemented to address the issue but did not disclose the material KPIs (such as employee turnover) that allow investors to measure progress against goals and the effectiveness of the current program
  - An energy company that identified climate risk as a concern in its financial reports but only provided emission data against annual goals. Therefore, it failed to demonstrate to investors how the company is managing the potential impacts of climate change on the company’s long-term strategy
- A grocery chain that has positioned itself as a leader in organic and healthy product offerings that are sustainably farmed failed to provide meaningful data on ESG KPIs such as supply chain and waste management
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Contact Us
We hope board members of our portfolio companies find this guidance useful. Any questions or comments may be directed to:

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