THE RISK OF BEING ‘OVERWEIGHT’ IN ALL THE WRONG AREAS
A review of the food and beverage sector

There are opportunities to capitalise on rising demand for food, driven by population and economic growth in Asia, as well as opportunities and risks related to changing consumer trends. On the flipside, it is also well-known that the world is facing an increasing problem of obesity and the food and beverage sector is exposed to a number of other sustainability issues.

AMP Capital recently conducted a major review of the food and beverage sector and this paper explores what some of the key sustainability drivers mean from an investor’s perspective. The paper also explores links between investment returns and companies’ management of environmental, social and governance (ESG) risks.

THE FOOD AND BEVERAGE SECTOR IS SUBJECT TO A SET OF RELATIVELY STRONG SUSTAINABILITY DRIVERS

While many sustainability issues facing the world are well established, the implications on investments can be complex. In-depth analysis of the industry-level sustainability drivers followed by analysis of how companies are exposed to these drivers and how they manage risks and opportunities from the external environment can help identify mispriced stocks or entire sectors.

Compared to other sectors, the food and beverage sector is subject to a set of sometimes overlapping, relatively strong sustainability drivers, some of which are long-term in nature and others that may have a more immediate effect.

Some of the key drivers include:

- **Demographic change**: population growth and rising income levels in Asia.
- **Changing consumer trends**: increased focus on ‘healthy living’, demand for convenience and affordability.
- **Regulatory change**: increased attention to obesity issues as well as social and environmental externalities.
- **Increased competition for constrained natural resources**: lack of arable land and need for yield improvement, competition for water and other scarce resources and impacts on soft commodity prices.
- **Increased consumer awareness of ethical and sustainability issues**: globalised supply chains and increased complexity, coupled with greater consumer awareness result in greater need for strong supply chain management.
- **Climate change**: potential regulatory changes and impacts of physical climate change on assets and resources.

IN THIS PAPER WE DISCUSS

- How the food and beverage sector is subject to a set of relatively strong sustainability drivers
- What the obesity issue means for investors
- How population growth in Asia means export opportunities for Australian companies.

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Måns Carlsson-Sweeney joined AMP Capital in September 2010 as ESG Research Analyst. In this role, Måns is responsible for the analysis of ESG issues and sustainability drivers for a number of sectors, as well as regularly engaging with companies on ESG issues.
WHAT DOES THE OBESITY ISSUE MEAN FOR INVESTORS?

How do you invest in a world that is constantly changing? A simple and straightforward answer would be to buy the companies that are changing the world. In other words, when it comes to disruptive negative sustainability drivers, as a general rule of thumb, investors can invest in the solutions and avoid the culprits. However, obesity is a multi-faceted issue, including consumer awareness levels, consumer choice and lifestyle, corporate responses and regulation.

ESG analysis can help identify issues and investment risks although the timing can be tricky. In some cases sustainability issues can be slow burners, although when change takes place, it can do so very quickly and swiftly change the industry dynamics.

As an example, obesity has been on the rise for decades, adding significant costs to already over-burdened government budgets, and the links between sugar and obesity have been spoken about for a very long time. Potential government responses to abate the costs to the public purse include stricter marketing rules and/or consumption taxes. However, until recently, few governments have acted in a significant way. One major exception is Mexico – a country with a very significant obesity problem – where the government’s decision to introduce an 8% tax on high-calorie food and a peso per litre tax on sugar-sweetened drinks in 2013 might be a sign of things to come elsewhere. Also, the US city of Berkeley in California recently became the first US city to pass a tax on sugary drinks and, at the time of writing, new measures are being discussed in the US as well as elsewhere in the world.

Empirically, there are few studies available on the long-term impacts of obesity-related taxes and consumption levels. This is ultimately a question about price elasticity, but in addition to raising prices, increased government regulation also results in greater consumer awareness. In short, we believe it is reasonable to expect that consumers will not care less about health issues in the future.

As a result of growing consumer interest in personal health, some of the fastest growing segments in the food and beverage sector include organic food and gluten-free. In contrast, consumption of sugary soft drinks and beer may be on a slippery slope.

SO, WHERE DOES THIS LEAVE INVESTORS?

Investors can reduce their exposure to companies and sub-segments at risk, although exclusions mean a reduced investible universe. While that means a potential investment risk, we believe it is true that most investors apply some form of refinement of their investible universe. The most important aspect is whether the refinement adds value or not. As we discussed in ESG – busting the myths in October 2014, by screening out companies with relatively poor ESG profiles – taking into account both industry-level sustainability drivers and how companies are managing their ESG risks - investors can generate a better pool of stocks to choose from.

The chart below shows the relative performance of a portfolio of ‘sustainable stocks’ (as measured by the AMP Capital Sustainable Fund’s investible universe and determined by AMP Capital’s internal ESG research team) and the ASX 200 index.

The portfolio of ‘sustainable stocks’ have outperformed the ASX 200 index

Our recent review of the food and beverage sector confirms this relationship, showing that, on average, companies with relatively better overall ESG profiles outperform those with relatively poor ESG profiles in both the short and the long-term.

Importantly, any exclusion needs to be dynamic as opposed to static. Evolution does not necessarily favour the strongest, but the most adaptable ones and companies currently negatively exposed to obesity may change. However, to date, many companies have been in denial about the global obesity issue although some are responding with new product areas or reductions in fats and sugars. Others have responded by reducing the size of food or beverage products. The question is whether the changes are sufficient to avoid regulatory change? Also, some food and beverage products and brands are so strongly associated with obesity today that turning around the negative brand perceptions might be costly and time-consuming or even not feasible.

To date, the fast food industry as a whole has benefited from increased demand for affordability and convenience, such as trends of people spending less time on food preparation at home. However, given the slow-down in supermarket earnings growth, the elephant in the room is what will happen to top-line growth and margins in the fast-food segment if and when supermarkets decide to target the take-away segment, similar to supermarket counterparts in the UK for example.

Health foods, although fast growing, still represent only a relatively small percentage of the total pie. As a result, the ASX200 index offers some interesting but still fairly limited opportunities to invest in the health food industry. Some of those that are on offer are also exposed to the risk of supermarket private label competition as supermarkets are under pressure to find new growth areas. Investors can also turn their attention to the healthcare sector where a number of companies are positively aligned with the obesity issue.

The chart below shows the relative performance of a portfolio of ‘sustainable stocks’ have outperformed the ASX 200 index
ASIA’S FOOD BOWL OR ASIA’S ‘SPECIALTY FOOD STORE’?

Australia has often been touted as a potential beneficiary of the ‘feeding the growing world’ theme. The world’s population is expected to increase by nearly a billion over the next decade and a major proportion of the population growth is expected to take place in Asia, which means export opportunities for Australian companies. However, there are several factors at play, including increased efforts to achieve improved self-sufficiency in food production in importing countries, politics, climate change as well as resources and capacity constraints. From an investor’s perspective, we believe the biggest opportunities exist in continued M&A activities by offshore investors and certain niche export areas.

When it comes to the latter, economic growth is typically coupled with increased consumption of protein. Interestingly, however, in some emerging countries, protein consumption per capita remains at subdued levels despite decades of economic growth, implying skewed wealth distribution. This, coupled with relative operational cost differences and logistics costs, leads us to believe that the cream of the crop of Australia’s export opportunities will likely be in the premium space, i.e. premium products to premium markets, particularly in protein. This means opportunities in infant formula for example, UHT milk, certain seafood categories and other areas where demand outstrips local supply, including certain nuts. We also see indirect export opportunities benefitting as feed producers and rural companies servicing the dairy industry for example, as well as companies that may assist yield improvements in a sustainable fashion. Exports of red meat currently benefit from increased demand but we regard live cattle trade as risky business.

Another import component in the food exports equation is water, which is the key scarce resource in food production. Going forward, we expect water risk will be exacerbated by climate change and risks of shortages. To assess export opportunities in the future, it may, therefore, make sense to analyse forecast economic value per unit of water consumed.

In addition to water’s role in food exports, we believe it makes sense to regard water as an investment theme in its own right (although currently, equity investors have few options available) and we see investment opportunities in companies focused on water efficiencies and providers of water efficiency solutions, quite similar to the energy efficiency theme in times of rising energy prices.

OTHER KEY ESG ISSUES THAT MAY HAVE A MATERIAL IMPACT ON INVESTMENTS

As mentioned above, the food and beverage sector is subject to relatively high sustainability risk. Some of these may have a direct impact on earnings. Others may not have a direct correlation with earnings or share prices, but collectively, the way a company deals with their ESG risks, may serve as proxies for management quality. In addition, as discussed above, we identified links between companies’ overall ESG profiles and total shareholder return. Some of the key ESG issues in the food and beverage sector include:

Corporate governance: our recent ESG review of the food and beverage sector covered 37 listed companies across Australia and New Zealand and highlighted a number of corporate governance issues, particularly structural ones, which in some cases are associated with the original company constitution. Of the companies covered, only slightly more than half had a majority independent board of directors. Also, approximately 40% had audit committees that were not fully independent and approximately 20% had audit committees that were not even majority independent. In addition, in several cases executive remuneration structures are not aligned with shareholders’ best interest. Combined, this represents a major risk for minority shareholders.

Supply chain management: globalisation means increasingly complex supply chains and exposure to a wide range of sustainability issues and ethical issues, including labour conditions, animal welfare, environmental issues, sustainability of critical resources and more, with implications ranging from brand risks and consumer backlash from sustainability issues in the supply chain to production disruption. Increased consumer concerns have already had an impact on how supermarkets operate and food processors need to adapt. We found a mixed bag in terms of how companies are overseeing and managing their supply chains.

Food safety and quality risk management: recent history is full of examples of investment implications from food safety scares. As a result, quality risk management is a critical intangible driver to focus on in ESG research into the food and beverage sector. While there is pressure to improve productivity and yields, there are various concerns about the impact on human health from growth hormones in beef production (illegal in the EU but legal in Australia and the US) as well as genetically modified crops. While the industry is heavily regulated on food standards, our analysis detected some negative trends in food and beverage product recalls for some companies as well as emerging risk areas.

Workplace management: the cost of poor safety management is going up, both in terms of direct and indirect costs, and occupational health and safety risk is relatively high compared to in other sectors. Few companies have comprehensive external safety reporting and while most of those that do report falling lost-time-injury-frequency rates, investors need to see beyond the reported statistics to understand the true safety culture and safety risks.

Environmental risk management: already significantly exposed to weather risk, on the whole, the sector is highly vulnerable to impacts from physical climate change, which is expected to lead to increased frequency and velocity of extreme weather events. This means risks of earnings volatility and supply chain issues. Few companies detail any strategies of how to deal with physical climate change risk and surprisingly many companies have poor reporting on their own environmental footprints.
FINAL THOUGHTS

The food and beverage sector is subject to relatively high sustainability risk compared to other sectors, including a number of overlapping drivers that can be narrowed down to changing consumer behaviour, regulatory change, resources constraints and climate change, population growth and increased demand for food. In our review of 37 listed companies we found that companies with relatively better ESG profiles outperform on average. This means investors need to understand the implications from sustainability drivers on investments as well as how companies are managing their ESG risks.

There is increased regulatory focus on the obesity issue, which is a major burden on the public healthcare costs. This, combined with increased consumer awareness about personal health, means structural challenges for companies that cannot adapt as well as investment opportunities in companies whose products are part of the solution. The food and beverage sector has food export opportunities although we believe these mainly apply to premium products to a premium market. Finally, the sector is subject to significant corporate governance issues, including poor board independence and poor executive remuneration structures, as well as a number of other ESG-related investment risks, such as climate change, workplace management, food safety, quality risk management and supply chain management. Given the link between companies’ ESG profiles and total shareholder return, investors doing in-depth analysis of companies’ ESG risk management might avoid investment blow-ups and outperform the market.

“Investors need to understand the implications from sustainability drivers on investments as well as how companies are managing their ESG risks”.

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