Contactus@
ausbil.com.au

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Australia: Not Asia's food bowl but maybe its deli

ESG Insight

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Ausbil Investment
Management Limited
ABN 26 076 316 473
AFSL 229722
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200
Fax 61 2 9259 0222

'Ausbil believes having proprietary in-house ESG research can provide better investment outcomes'

Overview

Ever since the announcement of the Australia-China free-trade agreement there has been significant investor interest in Australia's agricultural and food & beverage sectors, which offer investors new hope in the wake of the resources sector slump. Ausbil recently carried out a major review from an ESG (environmental, social and governance) perspective to assess key investment risks and opportunities.

With increased demand for protein on the back of rising economic wealth in Asia, Australia has sometimes been touted as Asia's food bowl. We don't believe that, but we believe Australia might have the potential to be its 'deli'.

While Australia's agricultural and food & beverage sectors have significant prospects on the back of various macro drivers, such as global population growth and increased demand for nutrition, coupled with potential supply constraints that may be exacerbated by climate change risk, we believe the practical reality for Australia's exports is different. Due to relative cost differences and logistics, Australia might have an edge for exports to Asia in a number of niche areas: we continue to believe Australia's key export opportunities are in premium products with premium pricing, such as infant formula, nutritional supplements, UHT milk as well as selected premium dairy, seafood and meat products. Organic food is another major growth area but is subject to supply constraint risk as ingredients often need to be imported.

However, within these segments, investors need to be selective due to a number of ESG-related blow-up risks: both company-specific ones and those that might impact entire industries and product categories.

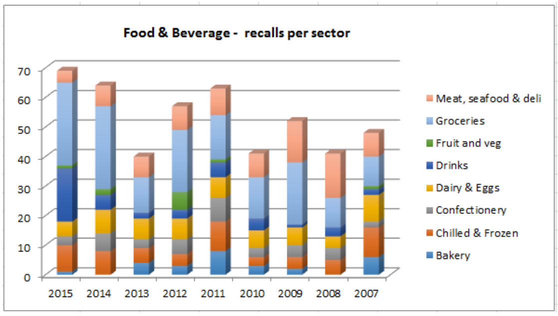
Key ESG risks

Ausbil believes assessment of ESG factors should be an integral part of fundamental stock research. The majority of a company's value comes from so-called intangible drivers, such as corporate culture, relationships with suppliers and customers and much more. Analysis of how companies manage their intangible drivers can help make better informed investment decisions. As a result, investors might be able to detect blow-up risks before it is too late. As discussed below, this might be particularly pertinent in the food & beverage sector. In addition, ESG analysis can assist in analysing a company's earnings sustainability, e.g. if a company's earnings rely on poorly informed customers and weak regulation, perhaps current earnings levels are not sustainable.

The agricultural, food & beverage sectors are subject to a wide range of ESG risks, such as occupational health and safety, environmental risk management, climate change and more, but leaving traditional corporate governance aside for a moment, we believe there is particularly high investment risk around potential food safety issues / quality risk management, worker exploitation and obesity.

High stakes for product quality issues – once trust is broken it may never be fixed again

Analysis of recalls in the food & beverage sector in Australia shows that there has been an upward trend in product recalls in 2007-2015. The graph below is a summary of recalls by category.



Source: www.recalls.gov.au

The reasons for and the nature of these recalls vary greatly. However, it could be linked to increased pressure to cut costs across the value chain – all the way from retailers down to supplier level. As a reminder of what can go wrong from an investor perspective, in early 2015, a number of people who consumed frozen berries were diagnosed with hepatitis A, which resulted in a major public product recall and a major dive in Patties Foods' share price. This case is interesting as the frozen berries had – up to that point – grown rapidly in terms of sales. After failing to recover the damage (which also impacted competitors), the company divested the business at the end of 2015. The share price has not regained the higher levels reached prior to the recall.

While the stakes for food safety issues are high in most categories, they are potentially very high in infant formula where the end consumers are very vulnerable. This is also an area where supply chain risk is highly concentrated. Infant formula has recently become a new goldmine in Australia as demand for Australian product from Chinese consumers has soared.

The demand for Australian infant formula is partly driven by China's own issues with food safety and consumer mistrust. The main issue goes back to 2008 and related to infant formula being contaminated with melamine, which resulted in over 50,000 babies being hospitalised and six dying from kidney damage. This followed another incident in 2004 where more than ten infants died from malnutrition due to watered-down milk. The market impact post these issues would suggest that once trust is broken it may never be fixed again.

Given the past incidents in China, the inital market reaction to product safety scares at a New Zealand dairy giant in 2013 were hardly surprising. The company had a major product recall after suspected botulism-causing bacteria were identified in safety tests of whey products that had been sold to other parties using it to produce infant formula. While no cases of sick people were reported (and eventually, the bacteria was found not to be the botulism-causing type), the issue resulted in a temporary ban on the import of the ingredient from New Zealand. Also, the company's Head of the Milk Business division resigned shortly afterwards.

How effective are vitamins and nutritional supplements?

The discussion on food safety and product quality risk management is also relevant for vitamins and nutritional supplements and other so-called complimentary medicines. Given the high demand coupled with limited supply, there could be a risk that some manufacturers might take short cuts on quality. In addition to potential quality risk, this category is also subject to another risk: efficacy. While infant formula is classified as a 'food' (therefore regulated by ANZFA – Food Standards Australia New Zealand), complimentary medicines are regulated by the Therapeutic Goods Administration (TGA). Data from the TGA shows that in 2013-15, there were 142 recalls in the 'Biological' category although a very small number of these related to vitamins and supplements.

While pharmaceutical drugs undergo significant clinical trials and approval processes, the process for complimentary medicines is very different. The TGA, which regulates anything with a therapeutic claim with the remit of quality and health risk, assesses the risk of all complimentary medicines. In addition, the TGA tests the product for quality concerns once the product is on the market. Of the 11,000 complimentary medicines that are registered, many are tested on efficacy. Non-compliant medicines are cancelled and all sales and exports must stop.

Ausbil's analysis of the data from the TGA on cancellations between 2012 and 2015 showed a total of 93 product cancellations involving 47 different companies, although 43% of the cancellations related to one individual company in 2014. Adjusting for that, there appears to be an increase in cancellations year on year. Also, although a major reason for cancellation has been administrative in nature, e.g. failing to provide information or documents about the certifications made in relation to the goods, two trends among cancellations appear to be contamination of raw materials and lack of evidence of efficacy. Companies need to be able to legally certify that the health benefits can be proven, which typically includes public data to back up claims. However, this is based on the ingredients as such, not necessarily for a particular brand. This is important given significant scepticism about the vitamin product category.

Exploitation of workers both overseas and on our home turf

In recent years, investors have learnt about the supply chain risks that listed companies face in countries such as Bangladesh, Thailand and Cambodia. For instance, the Thai fishing industry has been in focus for trafficking and slavery. The industry is responsible for a large proportion of Thailand's exports. However, Australia has had its own issues, such as the media revelations about exploitation of workers in the fruit and vegetable supply chain, which also put the spotlight on the country's supermarkets as well as fast food outlets. The allegations concerned widespread exploitation of foreign workers in the supply chain, particularly migrant workers. As with the food safety risks (discussed above), the risk might be exacerbated by an increased cost focus.

The last 12 months have seen a continued stream of revelations about wage issues and exploitation of workers in Australia. One of the high-profile cases was 7-Eleven where media revealed a major wage fraud cover-up. In that particular case, systematic compliance issues were detected. Both the chairman and CEO resigned from their roles in the wake of the scandal. The scandal was a stark reminder of the potential impacts from legal non-compliance and highlights the importance of strong corporate governance standards.

However, the exploitation issues are unlikely to be unique to 7-Eleven. The new chairman of 7-Eleven has suggested the company's issues were just the tip of the iceberg for exploitation of workers in Australia, particularly young and foreign workers. As a result, many other companies may be at risk.

Obesity – time to trim the investment portfolio?

The obesity issue is a major disruptive force and for investors it can be a complex issue with many moving parts, including changing consumer preferences, regulatory changes and corporate adaptation. How investors play the 'obesity theme' may depend on their investment time horizon but investors can no longer ignore increased consumer awareness and changing attitudes. The wellness sector is a fast-growing segment while segments negatively exposed to obesity, particularly sugar, are facing headwinds.

In addition to changing consumer preferences, governments faced with a combination of budget constraints and rising costs for healthcare are increasingly looking at measures to effectively combat obesity. Internationally, a number of different government responses have emerged, e.g. the tax on high-calorie food and tax on sugar-sweetened drinks in Mexico. While the long-term earnings impact from regulatory changes such as sugar taxes depend on price elasticity, regulatory changes also have an educational element for consumers which can accelerate the demand slowdown. As discussed above, earnings that rely on weak regulation or poorly informed customers are rarely sustainable.

The 'obesity' theme is well documented and presents both opportunities and risks for investors. On the one hand, there are areas of fast growth, e.g. gluten free and organics. At the other extreme, there are food & beverage companies that are negatively exposed and with limited possibility for adaptation to changing consumer and regulatory trends, for which it is hard to see an easy transition.

Proactive assessment of risks before it is too late

Investors face a number of risks, including those discussed above, but how should investors evaluate such risks proactively? When it comes to food safety and quality risk, we believe there are two ways: assessing direct risks and assessing indirect risks. Both involve identifying early warning signals.

Direct risks involve reviewing historical performance on food safety. For instance, has the company had any recalls in the past? What did they relate to, how were the issues detected and what changes has the company implemented since then? It also involves assessing the food safety standards in place. This includes a review of accreditations, certifications and risk management systems a company has in place for both its own manufacturing facilities as well as those of their suppliers. Certified quality risk management systems involving independent third party audits can provide confidence.

Tatura Milk Industries (subsidiary of Bega) operates with a Tatura Milk Quality Program accredited by Dairy Food Safety Victoria and provides on farm quality assurance. Every load of milk is individually tested. The factory uses the HACCP based quality system for Dairyfood Safety.

Source: February 2016, M. Carlsson-Sweeny, Ausbil field trip.

Supply chains are increasingly complex and often global, which means mapping out the supply chain and where the risks lay can be a time-consuming task. However, as illustrated by share price reactions to food safety issues in the past, investors who take the time may well have greater downside protection. Potential risk flags, or at least risks to investigate, can include, for example companies changing suppliers and companies changing country of origin.

In-depth studies of supply chains can also detect labour exploitation risks on a proactive basis.

In addition to direct risk, investors can see a company's general ESG profile as a proxy for risk management. In our experience, this is a relationship that holds true in many industries. In other words, while perhaps unrelated to specific food safety risk management, a company's occupational health and safety as well as environmental risk management can act as proxies. For instance, investors might assess trends in a company's injury statistics and environmental compliance to gage a company's risk management in other areas, including that of food safety.

In our experience, major blow-ups rarely occur in well governed companies that have strong general ESG risk management. This is why Ausbil believes having proprietary in-house ESG research can provide better investment outcomes.

Conclusion

Australia is unlikely to ever become Asia's 'food bowl', but Ausbil believes it may become its 'deli', i.e. a provider of premium product at premium pricing in a number of selected categories. Applying ESG analysis can help identify risks before they blow up and it can assist investors in assessing a company's earnings sustainability. While ESG analysis can assist in finding company-specific risk, the impact from a food safety scare for one company can have far-reaching implications for an entire industry or a country's industry, as was the case with China's milk scandal and temporarily, New Zealand's. Too much cost focus can also result in labour rights issues. This is why the sector as a whole presents major opportunities, but risks remain.

For further information please contact your Key Account Manager or Måns Carlsson-Sweeny, Head of ESG Research on 02 9259 0200.

Ausbil Investment Management Limited
ABN 26 076 316 473
AFSL 229722
Level 27
225 George Street
Sydney NSW 2000
GPO Box 2525
Sydney NSW 2001
Phone 61 2 9259 0200
Fax 61 2 9259 0222