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Investments

Sugar, obesity and noncommunicable disease: Investor expectations

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Schroders and Rathbone Greenbank:

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Investor objective

The fundamental aim behind these investor expectations is to better understand what food & beverage companies are doing to in response to the global rise in obesity and noncommunicable diseases (NCDs), which is a condition or disease that is non-infectious and non-transmissible among people. Our research has shown that the sector is exposed to increased regulation, changing consumer behaviour and greater scrutiny from public health bodies. It is our intention to seek an improved understanding of how companies are responding to these risks and opportunities in order that investors are able to better differentiate between leaders and laggards and reflect this in our company valuations.

Investor expectations

We have outlined below five core principles, with additional detail on pages 7 & 8. The aim of these principles is to provide better insight into how companies identify risks and opportunities and what management systems and metrics are used to evidence progress, so that investors can have confidence in a company's ability to mitigate risk and respond to new opportunities. We explain how investors may use this additional information. Acknowledging different investment styles and approaches, some investors may factor this information into their company valuations through EPS (earnings per share) adjustments, changes to the multiple or variations in cost of capital.

1. Governance:

Core expectation: Defined board management governance processes which routinely review risks from increased regulation of unhealthy food, sugar in particular.

Investment rationale: This information will help investors understand board level oversight and effectiveness of the company's risk management systems.

2. Strategy:

Core expectation: Clear strategic goal to adapt to health and wellness trends by providing a balanced portfolio to respond to increasing regulation and changing consumer tastes. Business models assessed for viability in the light of different scenarios for regulation of sugar, promotion of healthy eating.

Investment rationale: This helps investors to understand how companies are planning to respond to opportunities and mitigate risk and whether this reflects their view of future trends.

3. Implementation:

Core expectation: Clearly defined plan for achieving strategic goals relating to health and wellness trends. Risk management embedded into processes which ensure business models remain robust in the face of changing policy dynamics.

Investment rationale: Additional insight demonstrating how a strategy is being implemented will allow investors to assess how effectively a company is responding to challenges and opportunities identified

4. Public policy position & lobbying:

Core expectation: Transparency on active engagement with public policy makers at national and international level in a manner consistent with guidance on public health.

Investment rationale: Increased transparency will allow investors to measure the consistency in company strategy and lobbying efforts

5. Demonstrating progress:

Core expectation: Evidence of policy implementation and sufficient disclosure to enable a fair comparison of performance between companies. Investors welcome views on the most relevant metrics for their sub-sector, business model and market focus.

Investment rationale: Providing greater transparency will allow investors to assess progress made, understand targets and what's achievable and be able to compare and contrast company performance.

As active investors, we intend to use any additional disclosure on the issues above to better inform our investment decisions.

Signed:

Jessica Ground, Global Head of Stewardship
Schroders

Signed:

John David, Head of Rathbone Greenbank Investments
Rathbone Greenbank

These principles have been endorsed by long term investors, representing £1.8 trillion AUM, who have committed to use these expectations to guide their dialogue with companies.

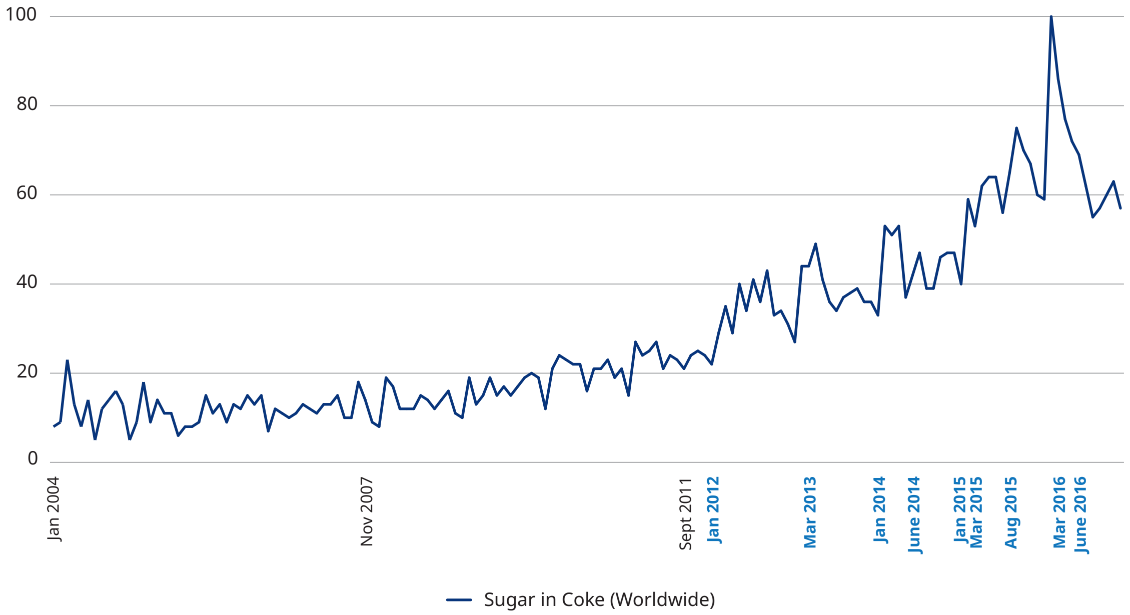
Is Sugar turning Big Food into the next Big Tobacco?

Our research suggests that there is rising consumer and political awareness of and concern about increasing sugar consumption. This is illustrated by the graph below, which shows the volume of google searches for sugar in a popular soft drink over time, demonstrating that increased political and media activity is driving further awareness. We believe that this increased focus will pose material challenges for the food and beverage sector. Central to this risk are a number of health problems, such as diabetes, high blood pressure and obesity (categories of NCDs) linked to excessive sugar consumption. We suggest that there are similarities between major food and beverage companies ('Big Food') and major tobacco companies ('Big Tobacco'), which have witnessed massive fines and legal settlements over the last 15 years. As investors, we want to understand how the companies we invest in are adapting to this issue but we do not yet have sufficient data to factor in these risks and opportunities into our valuations. Our current estimates suggest that should regulatory pressure and consumer pressure continue at current rates that the impact on EPS could range between 3 – 25%, depending on exposure to sugar. Without greater transparency from the industry we are unable to more precisely quantify the risk and/or opportunity for earnings, or identify potential winners and losers.

The aim of this document is to support investor engagement on the risks and opportunities posed by the emerging health concerns associated with unhealthy eating and increased sugar consumption in particular. By building a framework for consistent information gathering and setting a baseline expectation for companies to follow, we hope to:

- Understand how companies are able to adapt in a future where consumer demand and regulation pressure continues to tighten significantly.
- Raise investor awareness of sugar-related risks within the context of public health debates.
- Identify leaders and laggards in the food, beverage and grocery sectors.
- Quantify and value risks and opportunities more effectively.

Google trends – Sugar in Coke



Jan 2012
France introduces sugar tax

March 2013
Spike in media attention following publication of Dr Lustig's book, Fat Chance, claiming sugar is addictive and toxic

Jan 2014
Sugar tax in Mexico introduced

June 2014
Mayor Bloomberg's attempt to introduce soda tax in NYC is defeated

Jan 2015
UK's government launches Change4Life healthy eating campaign, sugar app and sugar tax in NHS hospital cafes

March 2015
WHO publishes its first recommendation on daily sugar intake

August 2015
Jamie Oliver's documentary, Sugar Rush is aired on TV

March 2016
UK government announces sugar tax, Ireland follows with similar announcement

June 2016
Philadelphia introduces sugar tax

Source: Google trends, Schroders
For illustrative purposes only and are not a recommendation to buy or sell

Background

The World Health Organisation (WHO), reports that global obesity has more than doubled since 1980. In 2014, more than 1.9 billion adults, 18 years and older, were overweight. Most of the world's population live in countries where overweight and obesity kills more people than underweight. An estimated 41 million children under the age of 5 were overweight or obese in 2014.

The rise in obesity has been caused by a number of factors, not least an increase in physical inactivity. However, there is also a major link to 'increased intake of energy-dense foods that are high in fat'[1]. Whilst the role of diets high in fat and salt has been long understood, the role of sugar in contributing to energy dense diets is a major area of emerging concern.

According to the WHO:

"Noncommunicable diseases (NCDs) are the leading causes of death and were responsible for 38 million (68%) of the world's 56 million deaths in 2012. More than 40% of those deaths (16 million) were premature (i.e. under the age of 70 years). Almost three quarters of all NCD deaths (28 million), and the majority of premature deaths (82%), occurred in low-and middle-income countries. Modifiable risk factors such as poor diet and physical inactivity are some of the most common causes of NCDs; they are also risk factors for obesity – an independent risk factor for many NCDs – which is also rapidly increasing globally. A high level of free sugars intake is of concern, because of its association with poor dietary quality, obesity and risk of NCDs."[2]

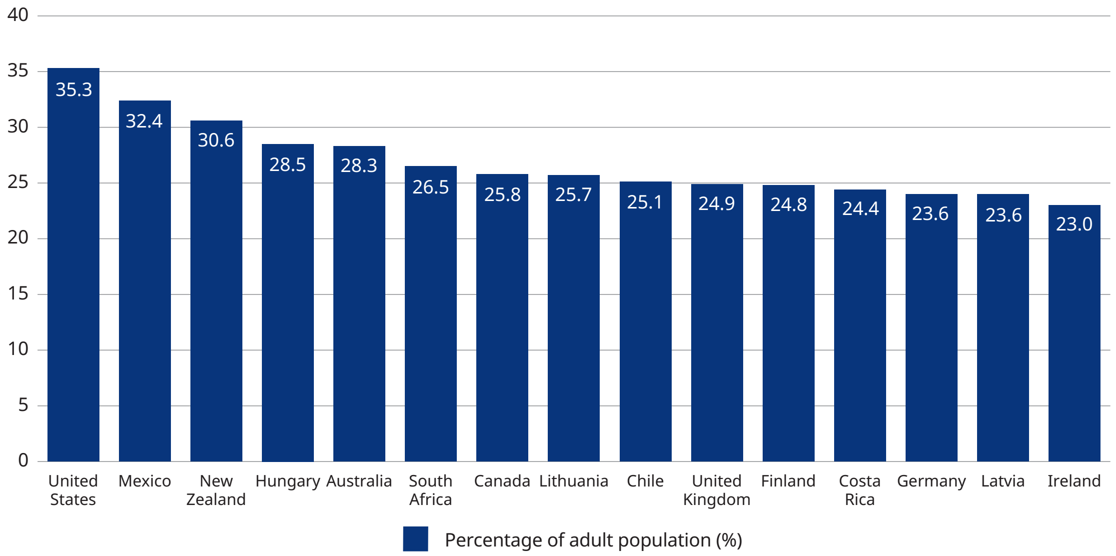
Defining sugar

The term 'free sugars' was used by the 2002 Joint WHO/FAO Expert Consultation on Diet, Nutrition and the Prevention of Chronic Diseases[3] in order provide a level of clarity on the health impacts of different ingredients beyond the use of the technical, chemical term 'carbohydrate'. The definition of the term 'free sugars' has been developed in the WHO Nutrition Guidance Expert Advisory Group (NUGAG) Subgroup on Diet and Health as follows:

"Free sugars include monosaccharides and disaccharides added to foods and beverages by the manufacturer, cook or consumer, and sugars naturally present in honey, syrups, fruit juices and fruit juice concentrates"[4].

The WHO recommends that if people do consume free sugars, they should keep their intake below 10% of their total energy needs, and reduce it to less than 5% for additional health benefits. This 5% level is equivalent to less than a single serving (at least 250 ml) of commonly consumed sugary drinks per day. Keeping to the 5% limit means limiting free sugar consumption to 25g a day[5]. Data from Euromonitor suggests that average per capita consumption of sugar is well in excess of these guidelines with consumption as high as 126g a day in the US, 103g in the Netherlands and 93g in the UK.

Global obesity rates



Source: OECD

1 WHO Factsheet "Obesity and Overweight" June 2016 http://www.who.int/mediacentre/factsheets/fs311/en/
2 http://apps.who.int/iris/bitstream/10665/149782/1/9789241549028_eng.pdf?ua=1
3 The Joint WHO/FAO Expert Consultation on diet, nutrition and the prevention of chronic diseases: process, product and policy implications, Chizuru Nishida, Ricardo Uauy, Shiriki Kumanyika and Prakash Shetty, 2002-04
4 Guideline: Sugars Intake for Adults and Children, WHO, 2015
5 NB This guidance is based on evidence relating to both the effect of high sugar diets on weight and on dental health. The WHO states that there is a relationship between a reduction in the intake of free sugars and reduced body weight; the specific guidance on 10% and 5% limits is derived from evidence relating to the incidence of tooth decay. The guidance is based on the totality of evidence, however.

Links to Noncommunicable Disease

Unhealthy, energy dense diets are risk factors for a number of noncommunicable diseases including:

Type 2 Diabetes	Hypertension	Coronary Heart Disease
Lipid Abnormalities	Cardiovascular Disease	Non-Alcoholic Fatty Liver Disease
Polycystic Ovarian Disease	Cancer	Dementia

Because the range of diseases is broader than just obesity, it affects a greater proportion of the world's population at a rapidly increasing rate. Research suggests that these broader set of diet-related diseases could affect as much as 52% of the US adult population, compared to 30% which are classed as obese[6].

Reporting in 2015, Public health England (PHE) stated that rates of obesity and overweight are on the rise at the cost of an estimated £27 billion to the UK economy.

Risks and opportunities – Investor perspective

We noted from the outset that the prevalence of NCDs related to overweight and obesity were wide-ranging, with multiple causal relationships. However, according to our analysis of both the issues and the historical voluntary responses from industry, exposure to sugar was noted to be a material risk which had not received sufficient attention compared with fat and salt content. Therefore our work has focused on corporate exposure to sugar as a lens through which to explore the corporate response to the crisis emerging with regard to overweight and obesity related NCDs.

As investors, we are primarily concerned with the risks and opportunities created by the emerging debate over sugar, obesity and noncommunicable disease. Whilst there are multiple causes of overweight and obesity, and the precise delineation of the causal relationships involved remains open to debate, investors are looking ahead to the best-and-worse case scenarios for policy and litigation.

Taking a broad view of the potential opportunities and risks, it is clear that the health concerns faced by the sector could become a material risk. We believe that there are three catalysts that could trigger lower sales, put pressure on margins and potentially expose companies to expensive legal disputes;

1 Consumer and public health awareness
2 Healthcare burden
3 Scientific consensus linking free sugar intake to NCDs.

6. Source: Sweetening the pot: Rethinking investment around food, CLSA, 2015

Evidence suggests that two of the three have already been triggered. The first, increased consumer awareness and attention from public health bodies, is already apparent from the decline in consumer demand for carbonated soft drinks (CSD) and the WHO publishing its first guidance on daily sugar intake. Secondly, the rising healthcare burden of NCDs caused by energy dense diets is putting pressure on governments to regulate. The UK's childhood obesity strategy stated that obesity alone is costing the NHS £5.1bn a year[7]. The growing awareness of the cost burden imposed on health care services by poor diet is fuelling further regulatory pressure as seen with the introduction of sugar taxes in Mexico, UK, France, Spain and Ireland as well as US cities including Philadelphia and Berkeley. Finally, we believe that there is an increasing risk of litigation against food and beverage companies is evident from recent cases of misleading health claims in the US[8].

Some speculate that product liability claims, similar to those in the tobacco industry, may in future pose a risk to the sector.

The increasingly clear link between sugar intake and NCDs may therefore have an impact on sales, but it does not present an 'existential threat' to companies in this sector, as there remains a significant opportunity to reformulate existing products and develop new products which take advantage of the trends we have identified. Whilst there is no safe reformulation of tobacco products which can offset its negative health effects, the same cannot be said of food and beverage products in general. There remains a major opportunity for leading companies to respond to the issue through policy and practice, developing a portfolio of products which satisfy consumer tastes, sales targets and advance public health policy goals.

These catalysts and the potential investment impact can be summarised as follows:

Risk

- Increased regulations
- Sugar tax
- Tobacco-like product warnings
- Lost sales
- Changing consumer trends

Catalysts:

1 Consumers and public health

2 Healthcare costs

3 Science

Outcome

- Lower sales
- Litigation costs
- Reputational damage
- Sector looks expensive
- Exposed to M&A and activist investors

=

Valuation

Current impact:

- Lower future growth rates
- Higher COGS[9]

Potential future impact:

- Litigation costs, liabilities and potential write downs = lower multiples due to lower growth and profitability

Opportunities to adapt product portfolio and generate higher sales

7 NB This guidance is based on evidence relating to both the effect of high sugar diets on weight and on dental health. The WHO states that there is a relationship between a reduction in the intake of free sugars and reduced body weight; the specific guidance on 10% and 5% limits is derived from evidence relating to the incidence of tooth decay. The guidance is based on the totality of evidence, however.

8 http://www.fda.gov/ICECI/EnforcementActions/WarningLetters/ucm440942.htm

9 Cost of Goods Sold.

Sugar roundtable – Lessons learned

Having reflected on the scale of the risks and opportunities, we sought the views of many companies from the food, grocery, beverage and ingredients sectors in order to establish a framework for robust corporate responses. Schroders and Rathbone Greenbank collaborated to create a 'Sugar Roundtable' to engage with a broad range of stakeholders. Two wide-ranging roundtable discussions were supplemented by many one-on-one meetings, resulting in a clear set of investor expectations. Further, these expectations were then reviewed by a range of stakeholders including companies, academics, investors and NGOs.

The observations are summarised below:

Multi-functional use:

- Sugar plays a very different role in distinct product areas. In the beverages sector, replacement with alternative sweeteners can play a much bigger role than in food products, for example. It also has a preservative effect in some situations.

Education:

- The interplay between 'expected and un-expected' sugars. That is, consumers may be well aware that certain product categories have a high sugar level, being positioned as occasional 'treats' or indulgences', but a major risk concerns the level of sugars found in high quantities in other product categories including dairy, cooking sauces and processed meals.
- Cultural factors relating to the tolerance for sugar substitutes perceived to be 'unnatural' will vary from region to region, as well as from individual to individual. This limits the effectiveness of top-down formulation efforts at a corporate level.

Acknowledging company differences:

- There is no 'one-size fits all' approach to managing the risks from sugar intake. Investors expect companies to formulate responses based on the precise understanding of their product ranges and geographic footprint.

Industry accountability:

- Across the industry sectors represented there was a consensus view that the obesity, overweight and NCD crisis is a result of multiple factors, and hence can only be solved through a range of interventions. Whilst investors accept that such a broad topic requires a multi-stakeholder approach, it is clear that businesses have a vital role to play regarding the most material risk factors. Investors are seeking evidence of progress made by this particular stakeholder group.

Relationship between corporate and individual responsibility:

- There is considerable debate about the scope and overlap of personal responsibility and corporate responsibility when it comes to unhealthy diets. On one end of the spectrum it is argued that individuals are entirely responsible for their own food intake, a view which minimises the role of companies in the debate. Others see personal choice as expressed within a context where certain actions are promoted above others and the companies themselves construct the context within which personal choice is exercised through marketing and product formulation. It is further suggested that the rapid pace of change and the scale of the problem points to an environmental cause as opposed to an issue of personal agency.

Lifestyle and individual responsibility:

- It was often suggested that the major cause of the obesity crisis was a combination of increasing calorie intake combined with increasingly sedentary lifestyles. It was consistently stated that in some areas, average calorie intake had remained static whilst exercise declined, resulting in the increase in obesity. By implication, companies argued that the responsibility for dealing with the crisis lay primarily with personal decisions on health, and hence demanded gentle reformulation and development of 'healthier alternatives' as opposed to wholesale change. This demonstrates the need to increase focus on in-store promotional activity over media advertising, where clear industry guidelines are already in place.

Emerging specific categories of risk:

- Whilst the strongest evidence exists around the key role of overconsumption of energy in causing obesity, emerging scientific evidence suggests that certain ingredients may carry particular and specific health risks, and that the risks of some ingredients being prevalent in the diet are not the same as others – in short 'a calorie is not just a calorie'. Hence, investors are concerned that current reliance on gentle reformulation and diversification into a broader range of product options will not be sufficient to manage the risks. Further, product labelling on calorie content – to date the major corporate response to the issues - is potentially misleading as calories do not correlate withy nutritional value. These leads to specific pressures on the producers of sugar sweetened beverages, which are energy dense with generally low nutritional values.

Progress to date:

- There is a clear sense that industry has been responding to this agenda for a number of years, but has not yet made the kind of progress that many demand. Many observe a growing frustration with lack of wholescale change as governments rely on soft, voluntary frameworks to encourage improvement. As frustration with the slow pace of development through voluntarism grows, there is an increasing risk of more stringent regulations. Whilst progress has been made on reducing fat and salt content, the concurrent emergence of sugar as an issue highlights the lack of consistent, comprehensive responses to the risks.

Investor expectations

We are seeking greater transparency from companies on how they are adapting to this material risk. We have outlined below five core principles. For each, we have outlined the areas where investors would welcome greater transparency and explain how investors may use this information. Acknowledging different investment styles and approaches, some investors may factor this information into their company valuations through EPS adjustments, changes to the multiple or cost of capital.

These expectations apply to any global consumer staples or discretionary companies that derive significant revenues from the sale of food and beverage products or ingredients (guideline is 20% of revenues or more) and/or fall under the following sub-industry classification according to GICS (Global Industry Classification standard): Restaurants, Movies & entertainment (cinemas), Food distributors, Food retail, Hypermarkets & super centres, Soft drinks, Packaged foods & meats.

Areas for board consideration:

1. Governance:

Core expectation: Defined board management governance processes which routinely review risks from increased regulation of unhealthy food, and sugar in particular.

Areas for increased transparency

- Does a board member have delegated responsibility for implementing health policy?
- Who is responsible for day-to-day implementation of the policy?
- How is the appreciation of health risks integrated into KPI (Key performance indicator) and remuneration metrics?
- Has the potential risk of legal disputes in this area been discussed by the board?
- What is the most material sugar-related risk for the company in question?

Investment rationale: This information will help investors to understand the board level oversight and effectiveness of the company's risk management systems.

2. Strategy:

Core expectation: Clear strategic goal to adapt to health and wellness trends by providing a balanced portfolio to respond to increasing regulation and changing consumer tastes. Business models assessed for viability in the light of different scenarios for regulation of sugar, promotion of healthy eating.

Areas for increased transparency

- How will the company operate in a future with increasing regulation and continued change in consumer demand?
- How is the company responding to these trends and how is this reflected in the company's strategy?
- What opportunities do the health and wellness trends offer?
- Are these issues identified on the risk register and are they reported in the principle risks within the annual report?
- Is the company considering the development and public disclosure of a nutrition and/or sugar policy?

Investment rationale: This helps investors to understand how companies are planning to respond to opportunities and mitigate risk and whether this reflects their view of future trends.

3. Implementation:

Core expectation: Clearly defined plan for achieving strategic goals relating to health and wellness trends. Risk management embedded into processes which ensure business models remain robust in the face of changing policy dynamics.

Areas for increased transparency

- What resource has been allocated to implement the company's strategy e.g. Chief Nutrition Officer or team?
- What R&D budget has been allocated or how is this changing over time?
- How are product portfolios being balanced across different categories e.g. indulgent versus healthy
- How will marketing strategy adapt to increasing restrictions and how will brand equity be protected?
- Is the group's business model routinely assessed against the likelihood of various policy options restricting the use or promotion of sugar?
- How are different options for product reformulation projected to affect sales?
- How is the appreciation of sugar related risks and opportunities linked to R&D into new products and reformulation of alternatives?

Investment rationale: Additional insight demonstrating how a strategy is being implemented will allow investors to assess how effectively a company is responding to challenges and opportunities identified.

4. Public policy position & lobbying:

Core expectation: Transparency on active engagement with public policy makers at national and international level in a manner consistent with guidance on public health.

Areas for increased transparency

- Does the company have clearly defined positions on key areas to ensure consistency application throughout the business?
- How does the company ensure that its policy positions are expressed accurately through any third party membership organisations or trade associations?

Investment rationale: Increased transparency will allow investors to measure the consistency in company strategy and lobbying efforts.

5. Demonstrating progress:

Core expectation: Investors are seeking evidence of policy implementation and welcome company views on the most relevant metrics for their sub sector, business model and market focus. Investors also ask for sufficient disclosure to enable a fair comparison of performance between companies.

The lack of availability of consistent data is a major area of concern for investors. Whilst we accept that every company is different, and that different products sectors require nuanced and specific governance frameworks, this core expectation remains,

Bearing this in mind, we suggest the following categories of potential KPIs. Whilst no company will find each and every such suggested indicator to be relevant to their business model, starting to assess these indicators will go a long way to kick-starting much needed industry wide progress.

Areas for increased transparency – Suggested KPIs and categories

Reporting Level	Suggested KPIs
Portfolio level	– Establish baselines for relative sugar content within portfolio/product lines so that investors can better understand the 'sugar footprint' of the portfolio – Reformulation progress, with clear definition of product improvements and definition of healthier products ro compliance with dietary guidelines – % change in R&D spend.
Product level	– Reporting on average reductions of sugarwithin product lines – Sugar levels per 100g serving – Changes in portion sizes – Compliance with calorie caps for certain specific single serving products.
By raw material	– Tonnes of sugar sourced per £ of revenue or absolute volumes. Tracked over time, appropriately normalised.
By Sales (by either volume or revenues)	– Proportion of sales from products deemed to be 'healthy', with a clear definition of healthy.
By specific guidance	– Report on % of sales or portfolio that meet WHO sugar or national dietary guidelines.

Investment rationale: Providing greater transparency will allow investors to assess progress made, understand targets and what's achievable and be able to compare and contrast company performance.

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