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FEATURE ARTICLE:

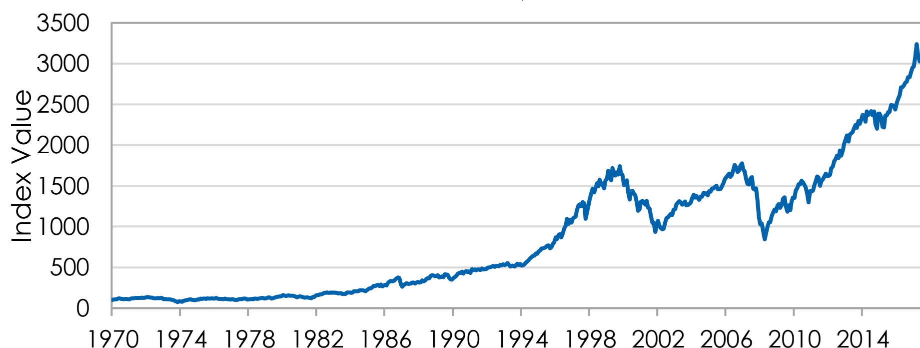
THE ROOTS OF GOODNESS; QUALITY COMPANIES, CONSUMER CHOICES AND ESG INVESTING

Introduction

Although they have commanded little attention recently, consumer staples companies such as food and beverage groups are a core part of many global equity portfolios. These companies have recently underperformed perceived growth sectors such as information technology and health care, but they are generally considered quality companies whose share prices have lower volatility than more cyclical companies. In fact, for many of these companies, the characteristics that cause them to be considered quality companies are the same ones that enable them to score well on standard environmental, social, and governance (ESG) investing criteria. These characteristics are largely coveted by companies whose customers, employees, and surrounding communities consider themselves satisfied with the companies' behaviour. Quality and ESG-focused corporate behaviour may thus be linked to an extent not fully appreciated by some investors.

At the dawn of the 1980s, a majority of the world's population was poor relative to today's standards. Air travel was expensive, oil prices were relatively high, and stock markets worldwide were low. But the 1980s, which began with recessions in the United States and Europe, and ended with the fall of the Berlin Wall and the Soviet Union, ushered in a new form of capitalism that was wholly focused on individual enrichment. If the 1970s was the 'me' decade, the 1980s was the 'me rich' decade. Greed was good. For corporations, this meant enriching themselves. For investors, it meant enriching themselves by investing in these corporations. As shown in Chart 1, the US equity market did not really begin to take off until the mid-1990s, but the roots of that increase are at least partly as a result of the deregulation of the 1980s.

Chart 1: S&P 500, 1970-2018



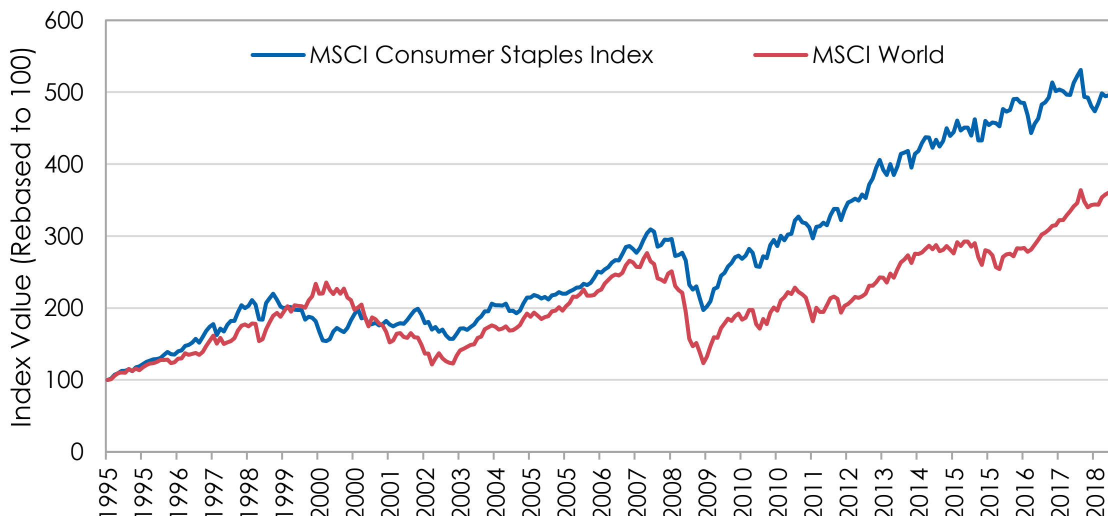
Source: Bloomberg

The context to today's attention to ESG factors and risks can be viewed through this background of unrestrained capitalism in the 1980s, when many grew rich, but others stayed poor – or at least became relatively poorer. It also has deeper echoes from an earlier period of capitalist history. At the beginning of the Industrial Revolution, some business owners – mainly of privately-held companies - sought to align their interests with the interests of their workers, by housing them and sometimes even educating them. Today's focus on ESG – whether in the strong form of investing according to ESG principles, or the integration of ESG risks - derives inspiration from both periods. We may be nearing the end of another 40-year era in which capitalism will need to learn to reinvent itself. Integrating the opportunities and risks that arise from ESG factors into investment decisions is one way of doing so, and investing in quality companies may facilitate this. This article explores this concept as it relates to consumer staples companies.

After a period of investor attention in the five years following the 2008-2009 financial crisis, consumer staples companies have fallen off the radar for many investors. Their performance, particularly in the past 12 months, has been sluggish, as shown in Chart 2. Most global equity investors – particularly those focused on future earnings growth – have turned to companies in the information technology, healthcare, and consumer discretionary sectors, which collectively appear to be signalling the likely sources of economic focus in decades to come.

But consumer staples companies have not gone away. From an economic perspective, most are as large as ever, and the products they provide are for the most part still considered essential. This research article evaluates consumer staples companies from a quality and an ESG perspective, and describes how the characteristics of quality investing and ESG investing are often linked, to an extent not fully appreciated by many investors.

Chart 2: MSCI Consumer Staples versus MSCI World, 1995-2018



Source: Bloomberg, Whitehelm Advisers

Consumer Staples as ESG Investments

A good company is more likely to do well than a bad company over the long run. Acknowledged or not, this simple statement is at the heart of ESG investing. If a company's doing good for the world and doing well as a company were incompatible, then ESG investing would simply not work: the companies best at doing good would go out of business. Most current large consumer staples companies still promote the idea that what they are selling is goodness – good for you, good for the environment, good for employees, and good for shareholders. Can all of these be true?

Consumer staples food and beverage companies are ideal test candidates for ESG evaluation, because they are easiest to potentially associate with goodness: they are stable, they employ large numbers of people; in many cases they provide products essential for human life. As investors, a positive ESG investing ideal might also be to support those companies that provide the most overall community – and by extension, environmental – benefits. By doing so, we indirectly support all of these objectives.

The picture, of course, is not that simple. There are two definitions of consumer staples. The first is essential products, such as food, beverages, and household items. That is a relatively broad definition. The second, however, is goods or services that people are unable or unwilling to cut out of their budgets regardless of their financial situation. This textbook definition of inelastic demand is the one that investors pay most attention to. Consumer staples mostly sell in all economic conditions. This fact also indirectly may lead to some of the criticisms that have been levelled at consumer staples companies over the decades, particularly in cases where their marketing interests have not coincided with the interests of nutrition or even food safety advocates.

The idea of normative 'goodness' is a powerful one. Many of the food-producing consumer staples companies began with some version of a slogan that the particular product they sold was 'good for you'. In the case of drinks, a variant of this slogan became a sort of magical thinking: the drink would make you feel entirely different, and give you an entirely new outlook on life. A whole line of drinks, from Coca-Cola to VitaminWater to Monster and Red Bull energy drinks, promotes this line of thinking. Throughout modern capitalist history, marketing a new drink has been one of the most promising non-technological business ventures. Kellogg's original dry cereal, for example, was meant to

help sick people become healthier. But this focus on goodness has changed over time. In part, it has been due to companies' relentless focus on satisfying consumer preferences: if something tastes better, people will buy and eat more of it, particularly if they *believe* that it continues to be good for them. Consumer staples food companies therefore have needed to balance their own beliefs about the nutritional qualities of what they sell with what they believe consumers will buy. Complicating this balance, in addition, is that collective beliefs about what is nutritious can change radically over time. The scientific promotion, and subsequent condemnation in the next generation, of high-fructose corn syrup as a sweetener is perhaps the best example of this type of collective belief change. Consumer staples food companies therefore operate not only in a changing financial landscape, but also in one of changing consumer and collective beliefs about health and nutrition.

The consumer staples stocks in global equity portfolios are typically very large companies with factories and operations around the world. Global consumer staples companies mainly produce non-perishable food and drinks, or those that can be transported, warehoused and distributed over multiple months. Additionally, many of them source a large amount of their raw ingredients from tropical areas located in developing countries. The large food companies within the MSCI World Index are Unilever, Pepsico, Nestle, Danone, Mondelez, Kellogg's, and others. The large beverage companies in the MSCI World Index are AB Inbev, Diageo, Heineken, and Coca-Cola, amongst others. The average annual sales of these companies are anywhere from US$20 billion to US$70 billion. Woolworths and Wesfarmers also have sales in this range, but as food distributors they generally have higher sales turnover and lower profit margins than global consumer food groups.

Quality Companies as ESG Investments

Virtually all of these global consumer staples companies have consistent year-over-year net profits and dividends, and as shown in Table 1 for a sub-selection, they also have other characteristics associated with quality companies: relatively high operating margins, low debt and a low cost of capital. These characteristics can be helpful in allowing such companies to focus on ESG considerations. A quality company is thus a strong candidate for having strong ESG credentials.

One ineluctable fact about most large consumer brand companies is that the majority of their assets consist of goodwill and intangible assets, rather than tangible assets. As many of these companies have grown through acquisition, goodwill and intangible assets have become a larger percentage of their balance sheets over time. These companies' tangible assets are less than their outstanding liabilities; an investor in such companies is not buying assets, therefore, but instead buying the future profits expected to be generated by brand-related revenues. Whether consumers would be better off purchasing generic-branded food is a question that has to some extent already been decided by supermarket chains' use of generic home brands. Still, there is still a large segment of the consumer population that chooses to purchase higher-priced branded food based on the perceived security and quality they appear to promise.

The beverage group of consumer staples companies – alcoholic and non-alcoholic – shares

many of the same characteristics of consumer staples food groups: stable earnings, generous profit margins (even after government taxes), low debt, and high intangible assets. Because of these characteristics, such companies may also have the opportunity to focus on how to maintain and improve their ESG credentials of providing environment and social benefits, as well as strong corporate governance.

Table 1: Financial Summary for Selected Consumer Staples Food Groups

Financial Measure	Nestle	Mondelez	Kraft Heinz	Kellogg's
Annual Revenues (US$ billion)	US$90	US$26	US$27	US$13
Operating Profit Margin	16%	16.5%	29%	16.5%
Revenue Growth (3-Year Average)	0.7%	-9%	-1%	-4%
Trailing Price/Earnings	31.0x	21.5x	6.6x	14.5x
Intangibles/Goodwill as % of Assets	80%	80%	70%	80%

Source: Company financial statements.

Table 2: Financial Summary for Selected Consumer Staples Beverage Groups

Financial Measure	Coca-Cola	Heineken	Diageo	ABInBev
Annual Revenues (US$ billion)	US$35	US$22	US$12	US$56
Operating Profit Margin	30%	14%	31%	32%
Revenue Growth (3-Year Average)	-8%	4%	4%	7%
Trailing Price/Earnings	85x	21.9x	21.6x	18.5x
Intangibles/Goodwill as % of Assets	19%	43%	42%	76%

Source: Company financial statements

(Non-ESG) Threats to Food & Beverage Consumer Staples Companies

A company like a consumer staples food or beverage producer may be attractive to investors because of its stable revenues and relatively high operating profit margins. Such a company may also be attractive from an ESG investing perspective because of its focus on providing essential products without harmful effects. Just as consumer preferences and collective beliefs change over time, however, so does the financial landscape in which these companies operate.

The shareholder focus that has given power to the ESG investing movement continues to have an uneasy coexistence with a longer-standing focus on optimal shareholder performance. To modify the original ESG investing thesis, a good company is likely to do better than a bad company over time, but a better-run good company is likely to do better than a poorly run one.

A company that has comfortable profit margins, stable earnings, low debt, and a low cost of capital, with diverse brands and a focus on adhering to ethical standards, is much more recession-proof from an investor perspective: what's not to like as an employee, shareholder, or manager of such a company? The problem, in the eyes of a financially-minded investor interested in optimising company performance for shareholders, is that the company – perhaps its employees, and certainly its managers – may have grown too comfortable. For an activist investor, a consumer staples company such as Nestle could have higher operating profit, higher debt, and more dynamic management. Leave aside the fact that the company has dominant market positions already in its respective consumer staples market. It is not doing enough: the very things that have made it a quality company are on the way to making it a mediocre company in the eyes of some.

Activist investing by agitating for change from the outside, however, is only a partial solution for some of these investors, though. The real solution is instead to take over the company's management itself. That is essentially what 3G, a consumer food and beverages group originally based in Brazil, has done sequentially with Anhauser Busch InBev (AB InBev), and with Kraft Heinz (in combination with Berkshire Hathaway), and will potentially do with more consumer staples companies in the future. 3G applies a private equity strategy, but applies it at a gargantuan scale, seeking to combine consumer staples food and beverage companies and operate the combined entities more efficiently.

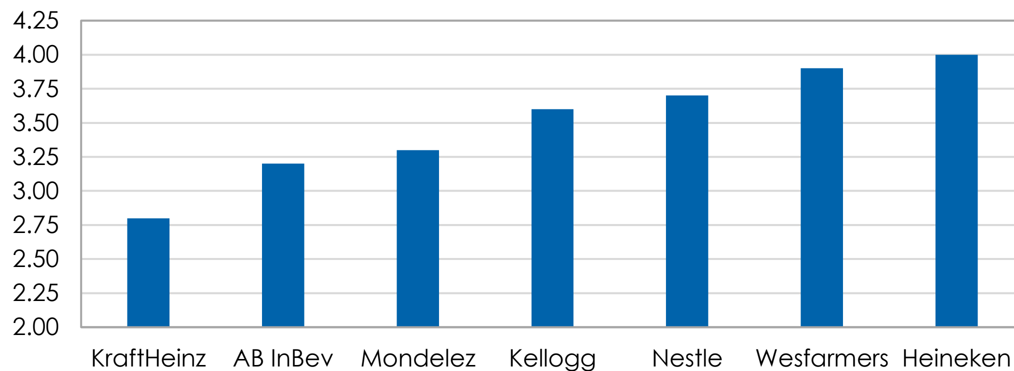
3G's playbook is primarily an operational improvement strategy. This manager usually takes on acquisition-related debt, for example, but then uses an expanded operating margin to repay this debt early from increased cash flow. 3G managers now control AB InBev's 70+ beer brands and US$70 billion in annual sales, and Kraft Heinz's US$26 billion in annual sales. As shown in Chart 3, AB InBev has by far the largest market share among the largest beer companies in the world. 3G operates on a ruthless cost cutting model that is designed to materially improve any company's operating margin. In fact, operating margins have improved in both companies that 3G runs, and even some companies in related industries have adopted the manager's zero-based expense budgeting (under which operating segment executives are forced to justify all expenses they need to make every year, not just new ones). Thus, even if the questions of whether consumer staples companies are quality investments and ESG investments may have been tentatively answered, the financial performance optimisation focus that has enabled activist and private equity investors to control large segments of the industry introduces new ESG questions in the balance between financial and ESG concerns: could a renewed focus on profit maximisation threaten the ESG characteristics of these companies?

New Competitors

A second financial threat to the consumer staples group is consumer preferences themselves, which has manifested itself in static or falling revenues. While the low growth and low inflation environment of many developed world countries since the 2008-2009 financial crisis does not make this particularly surprising, a number of consumer food groups are experiencing declining revenues, or revenues that would be declining if not for growth in developing country sales. In most cases, however, consumer staples company sales are declining not only due to low economic growth, but also due to consumer preferences: people are not buying as much of these companies' products, but are instead buying more of new competitors' products, particularly if they appear to offer better nutritional value. Greek-style yogurt, which was not even made by any large US consumer food group ten years ago, now accounts for 50% of the US market. Even without 3G or activist investors, most consumer food companies have realised they need to do something about new competition.

However, their first response is often not to look for ways to increase sales. Much has been written about the tendency of large technology companies to forestall competition by buying competitors. In fact, large food and particularly beverage groups have been doing so for decades as the easiest way of generating sales growth. While absorptions such as these eliminate competition, potentially increase revenue growth, and can add economies of scale, particularly in distribution, over the medium term, they risk diluting the qualities that made the competitor company's products attractive in the first place. Ben & Jerry's, for example, often disagreed with management as to the degree of quality required in its premium ice cream after its acquisition by Unilever in 2003. For the most part, these consolidations have only stopped revenues from falling, rather than increasing them.

In addition, labour practices are becoming more prominent among many ESG focused investors, particularly those with public stakeholders. One indicator of long-term corporate success is the overall health and well-being of a company's employees. Echoing the original 19th century utopian view of industrialisation held by some, under one school of thought, a company should ideally desire to have satisfied employees, because they are more likely to be productive and attract higher quality employees in future. The opposite view is that both managers and workers are better being kept in a constant state of low to moderate level fear for their jobs. Management consultants, rather than 3G, probably bear most of the blame for this practice, which is fairly widespread in large corporations. One happy result of data science and social media, however, is that the *aggregate* opinions of employees are much more publicly available than ever before, and over a large enough sample can be said to be representative of employee sentiment about a company. Quantitative equity managers themselves have begun using employee sentiment scoring as a medium-term indicator of a company's future stock performance. A sample of these aggregate opinions is shown in Chart 4.



Source: Glassdoor. Companies ranked on an aggregate scale of 1-5.

What do the employees of large consumer staple groups say about them? Perhaps not surprisingly, the majority view their employers favourably. Perhaps not so surprisingly, again, the two companies in the consumer staples category that score among the worst are the two 3G controlled ones, AB InBev and Kraft Heinz. After the arranged merger of Kraft and Heinz by 3G and Berkshire Hathaway in 2015, 3G proceeded to consolidate operations, including terminating up to 15% of its employees. On the other hand, operating profit margins at the combined company have significantly improved (the company's operating profit margin is an astonishing 30%), even though sales have declined in the merged company. This is both a difficult ESG case and a difficult financial case: from an ESG perspective, on one hand, Kraft Heinz produces cheap food that is readily available to people with limited time and money to shop for it. It is highly unlikely that such a person considers the ESG implications of their buying a package of Oscar Mayer bologna or a ready-to-eat (or 'ambient') meal. On the other hand, factory wages at Kraft Heinz, whose operations are based primarily in the US, are relatively poor in comparison with other developed countries.

As the founder of Chobani yogurt points out, it is an unfortunate fact that most people in minimum wage jobs in the US are unable to afford the time and/or money to buy and prepare nutritious food for their families.

Only a minority of large consumer staples companies have has taken the aforementioned 3G approach to date. Faced with a situation of stable profit margins, but static or declining sales, a segment of these companies has continued to focus on increasing sales organically, rather than through continued acquisitions. Some, like Diageo, appear to be doing so primarily through the tailwind provided by increased developing markets consumption. Others, however, such as Heineken and particularly Unilever, have been able to increase sales across most regional markets uniformly. The strategies for these companies have differed, but a common theme has been a focus not on reducing costs, but on increasing sales through reinvestment in brands, employees and research. Whether doing so can be considered more financially advisable or more advisable from an ESG standpoint, however, are both open questions.

Industry Structure and ESG Investing

Beyond financial optimisation, a further potential threat to the ESG credentials of consumer staples food and beverage companies is industry structure itself. The threat of new competition, changing consumer tastes and activist investing to established consumer staples companies does not obscure the fact that most are global oligopolies. Whether they attempt to increase sales organically or through serial acquisition, companies such as Nestle and Mondelez in chocolate, coffee and sweets, AB InBev and Heineken in beer, and Coca-Cola and Pepsico in soft drinks have become so large that smaller companies, upon reaching a certain size, will be faced with the decision of whether to continue competing against their large global counterparts, band with other competitors, or agreed to be acquired. Hence Dr. Pepper and Snapple combined in alternative soft drinks, Keurig and Green Mountain combined in coffee, and then the two combined companies themselves combined.

Such global duopolies themselves may be not conducive to the ESG focus of consumer staples food and beverage companies. From the standpoint of nutrition, most companies that offer a 'new' food or drink tend to market it as having better nutritional value than an established product: 'HonesTea', for example, was marketed as a low-sugar version of Nestea iced tea when it was launched in the late 1990s; the company was acquired by Coca-Cola a little more than ten years later; Ben & Jerry's ice cream was marketed as a 'super-premium' ice cream made without non-dairy thickeners, sweeteners, or injected air; the company was acquired by Unilever in 2003. An acquiring company, by contrast, may logically tend to attempt to reduce costs – often through substituting cheaper or less nutritious ingredients. There is thus an inherent tension in corporate consolidations between the profitability objective held by investors and management, and the potential disadvantages to quality and consumer prices paid.

Historically, this tension has been bridged by government regulators. But except in limited cases, government regulators have been mostly absent through most of the past three decades since the 1980s, in consumer staples and elsewhere, in many countries around the world. Part of the challenge is that multi-national companies by definition span multiple regulatory regimes, and thus have greater ability to navigate them than a business that is focused in a single country. Rather than governments, it is instead the private sector investing world that has led the crusade against poor corporate behaviour. Because ESG-focused investors can threaten companies not only with the collective weight of investor disapproval and the implied threat of share price punishment, they have arguably been more effective already in influencing corporate behaviour.

Finding the Middle Ground

In the middle of the 20th century, the ideal solution for companies that created environmental or social problems was increased government regulation. An electric power generation company that polluted the atmosphere through coal emissions, for example, was said to create 'externalities', in economic terms; the solution for these externalities was generally to tax the company more heavily for these emissions. In the 21st century, we have already moved far beyond this model through ESG-focused investing. The solution is effectively now a private market one: force companies to change their behaviour based on implicit investor demand for them to do so.

This new investor-led model, however, introduces new challenges in its implementation. Unless there is general agreement as to what constitutes poor company behaviour, investor-led actions to change this behaviour run the risk of making a company schizophrenic as it tries to satisfy all investor constituencies. The advantage of government-led behavioural guidelines - enforced through taxes and regulation – is that most governments usually agreed on what was poor behaviour: their economists and regulators usually followed whatever economic orthodoxy was dominant at the time, such that all regulators agreed that the best way to address excessive pollution by a company, for example, was through taxes and regulation.

The supplanting of this old model by the new investor-led one has meant that, just as in news and social media, there is an ongoing risk of a fragmentation of investor beliefs and preferences as to what constitutes poor corporate behaviour. Environmental and social effects are perhaps the easiest to agree upon, but the list of poor corporate behaviour could include behavioural manipulation, deceptive sales practices, limited access to corporate information, lack of concern for consumer privacy, company ethnic and gender diversity, and – for consumer staples companies – lack of sufficient concern for nutritional value and the health effects of consumption. Very few, if any, companies will be able to satisfy all investor concerns worldwide all of the time.

This research article has shown that quality consumer staples companies are expected to meet basic ESG criteria, but despite their professed focus on nutrition, the considerations that have allowed such companies to meet ESG criteria are primarily financial and operational ones such as stable revenues and profit margins. Finally, even if a consumer staples food company manages to satisfy both quality and ESG investment criteria, it is still at risk of morphing financially, operationally, and ultimately with respect to ESG considerations due to the demands of corporate activits who profess to value shareholder financial concerns above these considerations.

Conclusion

Consumer staples food companies have different characteristics from each other, but most should have views on how to balance profit maximisation and positive ESG behaviour. An institutional investor might consider combining its focus on ESG investing with a focus on quality investing, as many companies have these characteristics in common. A quality company whose employees, customers, and surrounding communities are happy with it can also, over time, make its shareholders happy.

Both quality investing and ESG investing involve strains of thought that have been around since the beginning of industrialisation. The difference this time is that institutional shareholders have taken corporate behaviour into their own hands, rather than relying on governments or consumer advocates to do so.

If a company makes good products or services that demonstrably benefit people, if it can also consistently be profitable, if it attempts to take some responsibility for the negative externalities it produces, if it treats its employees fairly, and if it does not seek to enrich its executives at the expense of these other groups, then it can arguably be considered to rate relatively well as an ESG-focused company. A company that is able to adapt to changing consumer preferences or norms, should be in a strong position to prosper over the long term. A quality company and a company that ranks well on ESG may thus be considered part of the same whole. Consumer staples companies are a good place to test this for truth.

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