

Global Equity Observer

# Plastic Matters

ACTIVE FUNDAMENTAL EQUITY | INTERNATIONAL EQUITY TEAM | INVESTMENT INSIGHT | SEPTEMBER 2019

Plastic is high on the corporate agenda. We reviewed our holdings to evaluate how this topical issue might influence the sustainability of company returns on operating capital, which is how we assess material risks and opportunities on any environmental, social and governance (ESG) issue. We believe that by addressing their plastic consumption, companies not only benefit the environment, but also create opportunities to differentiate themselves.

The world is drowning in plastic. A 2016 report (*The New Plastics Economy: Rethinking the future of plastics*) by the Ellen MacArthur Foundation predicts that, based on current trends, there will be more plastic in the oceans than fish come 2050. Around half of the total plastic produced is used for consumer goods packaging, usually single use, and very little is recycled, whether due to economic or technical reasons. We believe taxes on plastic packaging, including outright taxes on virgin plastic, higher waste processing fees and the introduction of deposit return fees, may all have a material effect on consumer staples companies in the future, unless they manage to adapt. In terms of cost, we have identified two main ways in which plastic may impact fast-moving consumer goods (FMCG) companies, in addition to reputation or brand damage.

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“Around half of the total plastic produced is used for consumer goods packaging, and very little is recycled”



**(I) PLASTIC TAXES AND REGULATION**

The aim of a plastic tax is not to raise revenues or reduce plastic use, but to encourage an increase in recycled content, e.g., a tax is levied on any packaging with less than 30% recycled content. We would anticipate any such tax being large enough to be noticed by packaging manufacturers (with their low margins) and their FMCG clients, but not so large that it would hurt final consumer demand if passed on.

The tightening of extended producer responsibility (EPR) rules would have a similar impact to the introduction of a tax. EPR means that companies producing any kind of waste have to pay the costs of dealing with it. The most comprehensive scheme is in Germany where brand owners are compelled by law to pay 100% of the net cost.<sup>1</sup> Meanwhile, in the U.K., the system only covers about 10% of the cost, although this is currently being reformed.<sup>2</sup> The European Union (EU), too, is reviewing EPR requirements across the bloc. To quantify the effect, we calculated the potential cost impact of such a scheme on an American beverage company we own. Should the whole world move to the German model, it would cost this company 4% of sales, while a move to the average EU cost would have an impact of 1% of sales.

Strong consumer brands have significant pricing power and have historically managed to pass a substantial proportion of their input cost inflation on to their customers. We believe this would also apply to plastic. Similar to raw material inflation, if regulation increases companies' costs, every company in a given country will be impacted similarly and will likely try to pass cost increases onto consumers. Given low price elasticity in consumer staples, we believe the volume impact of such industry-wide price increases would be limited.

**(II) INCREASED COST OF RECYCLED MATERIAL**

There are over 400 signatories to the Ellen MacArthur Foundation's New Plastics Economy Global Commitment, representing over 20% of global plastic packaging use. Their aggregate commitments to increase recycled content amount to five million tonnes of additional demand for recyclate by 2025, compared to current market demand of what we calculate to be around three and a half million tonnes. Such a significant increase in demand may, in the medium term, push the premium up until enough capacity comes on stream.

“Key issues are plastic taxes, the increased use and cost of recycled plastic, and brand impact”

**ENGAGING ON PLASTIC**

With consumers ever savvier about responsible corporate behaviour, our engagements with the FMCG companies we invest in show they are taking plastic waste seriously and, in preparation for the upcoming impact of stricter regulation and plastic taxes, have dramatically increased their commitments to virgin plastic reduction. Plastic may not currently represent a material risk to the sustainability of returns of consumer staples companies, but the potential of it doing so in the future, not to mention reputational damage, is too high to dismiss.

As we detail in our Engage report, we met with eight of our FMCG holdings, including those in beverages and household and personal care, on plastic waste. As well as an important environmental issue, plastic waste may impact the reputation and cost base of those who fail to adapt to the future reality of the new circular economy.

Our engagements with the companies we invest in show they are taking plastic waste seriously. Although the single-use plastic problem is very complex and will not be solved overnight, most of our holdings, which are among the largest consumer staples companies, are likely to lead the rest of the FMCG industry in terms of focus, allocated resources and public commitments to reduce plastic waste. Although meeting these commitments may result in somewhat higher costs in the near term, they are manageable and should protect the companies from potentially elevated risks including increased regulation, such as taxes on virgin plastic, higher waste management costs or plastic bans.

“Our engagements with the companies we invest in show they are taking plastic waste seriously”

<sup>1</sup> Source: LSE Research Online: 'Packaging waste recycling in Europe: is the industry paying for it', Ferreira da Cruz et al., 2014.

<sup>2</sup> Source: Consultation on reforming the U.K. packaging producer responsibility system, Department for Environment, Food and Rural Affairs, February 2019.

There is no single solution to the single-use plastics problem given the sheer scale of virgin plastic production and society's dependence on it. Every possible avenue of improvement should be pursued. We believe solutions should involve governments and consumers as well as companies. During our engagements we discussed company-specific strategies and targets as well as the hurdles to achieving them.

**“Most of our consumer holdings have now publicly committed to significantly increase recycled content in their plastic packaging”**

In the case of FMCG companies, the most practical near-term solution is increasing the percentage of recycled content in their packaging. This should increase demand for recycled plastic and encourage badly needed investments in the collection and recycling infrastructure. As part of the Ellen MacArthur Foundation's Global Commitment, most of our consumer holdings exposed to plastic packaging have now publicly committed to significantly increase recycled content, from less than 10% in most cases to 20-50% by 2025.

Although this will definitely not solve the problem by itself (the largest FMCG user of plastic accounts for only about 2% of global plastic packaging volumes), it should protect these companies from future regulatory risks, such as potential taxes on virgin plastic (the U.K. was the first country to announce one), or reputational damage if consumers eventually start penalising brands they view as not addressing the problem. These incremental commitments should provide a material demand boost for the currently small recycled plastic market.

Other initiatives undertaken by our holdings include partnerships with, and investments into, innovative start-ups that explore breakthrough technologies in chemical recycling, work on circular/refillable packaging, or try to find new ways to improve plastic waste capture in emerging markets. They also continue to work on simplifying and reducing the weight of their packaging and increasing its recyclability (which already ranges between 70-100% in most cases).

We encouraged the management of one of the beverage companies we hold to allocate a greater proportion of their sizeable annual charity donations towards projects related to tackling plastic waste in emerging markets. The company shared with us that it was already in their plans—we will monitor future developments.

As part of our engagement and research we tried to assess the cost impact of this move to a more sustainable, circular plastic supply chain. Despite the potential temporary increase in prices of recycled plastic due to higher demand, we believe that the cumulative impact is likely to be limited to a low single-digit percentage of sales.

Another finding was that more companies are starting to use circular plastic as a marketing tool by converting certain brands' packaging to 100% recycled plastic, and advertising this on the pack and in the media. We believe this is important for the long-term health of their brands as more consumers, particularly younger ones, make brand choices based on sustainability credentials.

**“The best way to implement ESG is directly at a company level—on a case by case basis—engaging with management on the key issues of the day.”**

We have always focused on high-quality companies with sustainable and high returns on operating capital, because we believe this is the best way to compound shareholders' wealth over the long term. Embedding ESG into our investment process is essential to this because it helps us identify any material risks or opportunities that could threaten or enhance these returns, whether it is plastics, or carbon, or executive incentives, to name but a few. We continue to believe that the best way to implement ESG is directly at a company level—on a case by case basis—engaging with management on the key issues of the day.

*In April 2019, Morgan Stanley launched its Plastic Waste Resolution, committing to facilitate the prevention, reduction and removal of 50 million metric tonnes of plastic waste from entering rivers, oceans, landscapes and landfills by 2030.*

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