

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.

AUTHORS



WILLIAM LOCK
Head of International
Equity Team



BRUNO PAULSON
Managing Director



VLADIMIR DEMINE
Executive Director

"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.¹ Meanwhile, in the U.K., the system only covers about 10% of the cost, although this is currently being reformed.² 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"

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

² 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.

Risk Considerations

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market value of securities owned by the portfolio will decline. Accordingly, you can lose money investing in this strategy. Please be aware that this strategy may be subject to certain additional risks. Changes in the worldwide economy, consumer spending, competition, demographics and consumer preferences, government regulation and economic conditions may adversely affect **global franchise companies** and may negatively impact the strategy to a greater extent than if the strategy's assets were invested in a wider variety of companies. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, and market risks.

Stocks of small-capitalisation companies carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Non-diversified portfolios** often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Option writing strategy.** Writing call options involves the risk that the Portfolio may be required to sell the underlying security or instrument (or settle in cash an amount of equal value) at a disadvantageous price or below the market price of such underlying security or instrument, at the time the option is exercised. As the writer of a call option, the Portfolio forgoes, during the option's life, the opportunity to profit from increases in the market value of the underlying security or instrument covering the option above the sum of the premium and the exercise price, but retains the risk of loss should the price of the underlying security or instrument decline. Additionally, the Portfolio's call option writing strategy may not fully protect it against declines in the value of the market. There are special risks associated with uncovered option writing which expose the Portfolio to potentially significant loss.

INDEX INFORMATION

The **MSCI World Index** is a free float adjusted market capitalisation weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends. The index is unmanaged and does not include any expenses, fees or sales charges. It is not possible to invest directly in an index.

DISTRIBUTION

This communication is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.

Ireland: Morgan Stanley Investment Management (Ireland) Limited. Registered Office: The Observatory, 7-11 Sir John Rogerson's, Quay, Dublin 2, Ireland. Registered in Ireland under company number 616662. Regulated by the Central Bank of Ireland. **United Kingdom:** Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. **Dubai:** Morgan Stanley Investment Management Limited (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158). **Germany:** Morgan Stanley Investment Management Limited Niederlassung Deutschland Junghofstrasse 13-15 60311 Frankfurt Deutschland (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Italy:** Morgan Stanley Investment Management Limited, Milan Branch (Sede Secondaria di Milano) is a branch of Morgan Stanley Investment Management Limited, a company registered in the UK, authorised and regulated by the Financial Conduct Authority (FCA), and whose registered office is at 25 Cabot Square, Canary Wharf, London, E14 4QA. Morgan Stanley Investment Management Limited Milan Branch (Sede Secondaria di Milano) with seat in Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy, is registered in Italy with company number and VAT number 08829360968.

The Netherlands: Morgan Stanley Investment Management, Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. Telephone: 31 2-0462-1300. Morgan Stanley Investment Management is a branch office of Morgan Stanley Investment Management Limited. Morgan Stanley Investment Management Limited is authorised and regulated by the Financial Conduct Authority in the United Kingdom. **Switzerland:** Morgan Stanley & Co. International plc, London, Zurich Branch Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered with the Register of Commerce Zurich CHE-115.415.770. Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland, Telephone +41 (0) 44 588 1000. Facsimile Fax: +41(0) 44 588 1074.

U.S.

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required. For important information about the investment manager, please refer to Form ADV Part 2.

Please consider the investment objectives, risks, charges and expenses of the funds carefully before investing. The prospectuses contain this and other information about the funds. To obtain a prospectus please download one at morganstanley.com/im or call 1-800-548-7786. Please read the prospectus carefully before investing.

Morgan Stanley Distribution, Inc. serves as the distributor for Morgan Stanley funds.

NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT

Hong Kong: This document has been issued by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong Kong (Cap 571). The contents of this document have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this document shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This document should not be considered to be the subject of an invitation for subscription or purchase, whether directly or

indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This material has not been reviewed by the Monetary Authority of Singapore. **Australia:** This publication is disseminated in Australia by Morgan Stanley Investment Management (Australia) Pty Limited ACN: 122040037, AFSL No. 314182, which accept responsibility for its contents. This publication, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

Japan: For professional investors, this document is circulated or distributed for informational purposes only. For those who are not professional investors, this document is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.16% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This document is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

IMPORTANT INFORMATION

EMEA: This marketing communication has been issued by Morgan Stanley Investment Management Limited ("MSIM"). Authorised and regulated by the Financial Conduct Authority. Registered in England No. 1981121. Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market. Prior to investing, investors should carefully review the strategy's/ product's relevant offering document. There are important differences in how the strategy is carried out in each of the investment vehicles.

A separately managed account may not be suitable for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing.

This material is a general communication, which is not impartial and has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision. Except as otherwise indicated herein, the views and opinions expressed herein are those of the portfolio management team, are based on matters as they exist as of the date of preparation and not as of any future date, and will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date hereof.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific Morgan Stanley Investment Management product.

MSIM has not authorised financial intermediaries to use and to distribute this document, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this document

is suitable for any person to whom they provide this document in view of that person's circumstances and purpose. MSIM shall not be liable for, and accepts no liability for, the use or misuse of this document by any such financial intermediary.

The whole or any part of this work may not be reproduced, copied or transmitted or any of its contents disclosed to third parties without MSIM's express written consent.

All information contained herein is proprietary and is protected under copyright law.

Explore our site at www.morganstanley.com/im