ESG Evolution: Conditions at food processors and distributors suddenly in the spotlight

Analysing workers' conditions, and their influence on market performance, in times of COVID

Food ethics play a role in market performance

During the outbreak of the coronavirus, a heightened awareness about the potential vulnerability of the food chain arose, and arose quickly. Despite a myriad of reports of potential shortages and hoarding, broadly the system held, at least in the US and Western Europe.

However this does not mean that specific issues did not come to the forefront during the pandemic. COVID-19 outbreaks at meat packing plants in the US[1] and Germany[2] were common, indeed even now Germany is responding to a new outbreak at a meat procession plant in North Rhine-Westphalia[3], challenging the previous success in Germany's efforts to contain the spread. In addition, there have been similar outbreaks in the UK in England in Wales[4].

Working conditions, which sometimes appear to take a back seat to environmental issues for investors, suddenly were in the spotlight – as Bloomberg Businessweek recently observed, "U.S. meat plants are deadly as ever, with no incentive to change"[5]. Similar issues have been raised around the safety of workers at food retailers as individual companies took different approaches to policies as wide as providing masks to sick leave to cash bonuses. This led to some strikes as workers demanded better protection[6].

In addition, four US poultry executives at two companies have been charged with price fixing, which is a particularly sensitive topic with food prices already on the rise due to the pandemic[7]. ESG was suddenly at the core of the food industry.

So with this heightened focus on the food industry and its treatment of employees, how did companies fare in holding up their end of the social contract with their workforce, during a historic pandemic and performing a clearly essential service to the population? And did investors take notice? This would be the perfect opportunity to put "S" considerations into practice, and to potentially have a meaningful impact on the intended outcomes. As the Businessweek article cited above points out, significant shifts towards more ethical production chains have taken place in other industries (garment, electronics) as consumers started demanding them. Investors could also play an important role in the food industry.

Notes:
1. https://www.theguardian.com/world/2020/may/15/us-coronavirus-meat-packing-plants-food
2. https://www.dw.com/en/coronavirus-outbreak-closes-german-meat-packing-plant/a-53374478
3. https://www.cnn.com/2020/06/18/europe/germany-meat-processing-plant-coronavirus-cases-intl/index.html
4. https://www.theguardian.com/business/2020/jun/19/three-meat-factories-in-england-and-wales-closed-over-coronavirus
5. https://www.bloomberg.com/news/features/2020-06-18/how-meat-plants-were-allowed-to-become-coronavirus-hot-spots?srnd=businessweek-v2
6. https://www.nytimes.com/2020/03/30/opinion/coronavirus-worker-strike.html
7. https://www.forbes.com/sites/jordanstrickler/2020/06/04/four-executives-charged-with-poultry-price-fixing/#6d630b76fded

Did worker conditions make a difference in equity performance?

We analysed a basket of 47 companies in the food chain, from production and processing, to packaging and distribution, to grocers and similar retail outlets. We rely on our own universe precisely to explore social issues across categories. The basket contains mainly companies in the US (85%), but also Western Europe, Canada, and Brazil. It is comprised of 49% large-cap companies, 26% small-cap, 19% mid-cap, and 6% mega-cap ($200bn and above). For analysis, we applied quantitative data from Arabesque S-Ray, a quantitative ESG scoring system that uses self-learning quantitative models and data scores to evaluate companies, and it updates on a daily basis (for more see https://www.arabesque.com/s-ray/).

We found that companies that saw the largest declines in their ESG Social scores (ESG-S) saw their stock prices underperform broader related indices, often seeing twice the magnitude of declines. The results on companies that saw ESG-S outperformance was more mixed, suggesting that other issues could outweigh the potential positive impact from improved social scores.

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When we dug deeper into specific scoring issues related to employee working conditions and safety, the results were even more telling: a basket of the worst performing companies in regards to those more specific metrics saw falls two to four times as much as the broader food and beverage market.

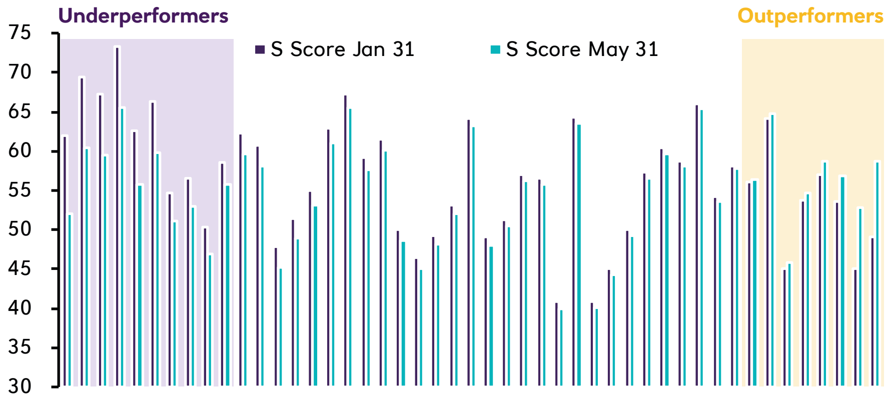
The big picture: overall social scores

The social underperformers underperformed

Of the 47 companies, 39 saw outright declines in their ESG-S scores between the end of January 2020 and May 2020, which are scored on a scale of 0-100 (higher numbers represent better practices). The starting period range of scores was 40.8 to 73.2. Most (25) of these were marginal drops of less than 1%, while several saw drops of nearly 10%. The fact that meaningful changes in the scores with a large dispersion between companies took place speaks volumes on the availability of high frequency data, which by itself is encouraging.

Chart 1: There was a clear dispersion of "S" scores among food producers S Arabesque scores in Jan 31 and May 31

Source: Arabeque S-Ray and NWM Strategy



We focused on three subgroups: the 10 worst performers, the 47 companies as a whole in our basket (our "Benchmark" group – i.e. if you had started with a cap weighted exposure to these companies), and the 8 companies that improved their ESG-S scores.

The average decline in ESG-S scores among the 10 worst performers was -6.1 points (around 10% of their initial score). As a group, their scores went from a better than average 62 to 56. During the analysis period, the worst performing group experienced an average fall of 14.9% in their equity prices. Indeed, the negative performance was widespread in the group with only 2 companies' equity price increasing. This compares to -2.5% for the Benchmark group, and -4.3% for PBJ, the Invesco Dynamic Food & Beverage ETF, which we are using as a broader sector gauge. For posterity, the S&P 500 during that period was -5.6%. These results are summarized below.

Table 1: Worst 10 performers, ESG-S score change and equity performance 1/31/20-5/31/20

Source: Arabeqsue S-Ray, NatWest Markets

	Score Change	Simple Average Returns	Market Cap Weighted Score Change	Market Cap Weighted Average Returns
10 Worst	-9.6%	-14.9%	-8.2%	-9.9%
Benchmark Group	-2.4%	1.2%	-3.1%	-5.8%
PBJ	-	-	-	-4.3%
S&P 500	-	-	-	-5.6%

As noted in Table 1, we also adjusted both scores and performance for market cap, because some of the underperformance was driven by smaller companies. As you can see, the performance of the 10 worst, when adjusting for market cap, was nearly exactly the same as our benchmark group, but still significantly worse than the PBJ index.

It is not clear if this means that the pandemic itself bore a greater brunt on smaller companies (including their ability to hold the line on Social performance), or if lower liquidity given smaller market cap means moves were exaggerated, but it is worth noting nonetheless.

The outperformers as a whole did not see as much benefit, though due to one industry's idiosyncratic issues

Of the 8 best performers (we would have used 10, but only 8 of the companies in our basket saw improvements in their social scores over the period), the average improvement in overall Social scores was 3.1 points (or 6.3% of the starting score). However, the performance data is more mixed. As Table 2 shows, on a simple average basis, the best performers saw their equity prices increase by 23.1%. However, when weighted for market cap, the performance was -21.6%, as the results are biased by a couple of small companies.

This brings out the possibility of an asymmetric response that penalizes negative news rather than reward positive developments, which we intend to tackle across our ESG analysis, and have already seen occurring in several instances. It may be the case that investors are quicker to sell poor performers or those that have negative ESG news, while improvements take more time to process and accommodate.

"This brings out the possibility of an asymmetric response that penalizes negative news rather than reward positive developments."

Table 2: Best 8 performers, ESG-S score change and equity performance 1/31/20-5/31/20

Source: Arabeqsue S-Ray, Bloomberg, NatWest Markets

	Score Change	Simple Average Returns	Market Cap Weighted Score Change	Market Cap Weighted Average Returns
8 Best	6.3%	23.1%	6.4%	-21.6%
Benchmark Group	-2.4%	1.2%	-3.1%	-5.8%
PBJ	-	-	-	-4.3%
S&P 500	-	-	-	-5.6%

In addition, the performance difference between simple average and market cap weighted returns was not only due to large swings in smaller caps, but also due to large underperformance in 2 large cap alcoholic beverage manufacturers, whose shares were down ~30% over the period (with bars and restaurants on lockdown, the industry never recovered like food and grocers did). Excluding those, the weighted average share gains of the best ESG-S performers was +1.4% - though we recognize by excluding those the data set is increasingly small.

Removing the small caps shows similar results

Given the influence of large share gains and losses amongst the small caps in both categories, we decided to exclude all small caps from the analysis, leaving us with 36 companies. The result is that the worst performers underperformed the broader PBJ ETF as well as the peer Benchmark group, while the results of the best performers still faced the issues noted above regarding 2 large alcoholic beverage companies.

Table 3: Excluding small-caps, ESG-S score change and equity performance 1/31/20-5/31/20

Source: Arabeqsue S-Ray, Bloomberg, NatWest Markets

	Score Change	Simple Average Returns	Market Cap Weighted Score Change	Market Cap Weighted Average Returns
10 Worst	-8.5%	-9.1%	-6.1%	-6.2%
Benchmark Group	-3.0%	-5.5%	-3.1%	-6.0%
5 Best	5.2%	-19.2%	6.4%	-24.0%
PBJ	-	-	-	-4.3%
S&P 500	-	-	-	-5.6%

In summary, it appears that investors did punish the underperformers for substantial declines in their ESG-Social scores, while the limited number of companies that improved, and the idiosyncratic impact of large alcohol producers, muddied the results there. Two potential lessons here: first that investors are quick to punish but slow to reward, and second, that while all things equal ESG issues do have an impact on performance, larger thematic or financial matters that greatly impact the bottom line still rule.

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Digging a little deeper

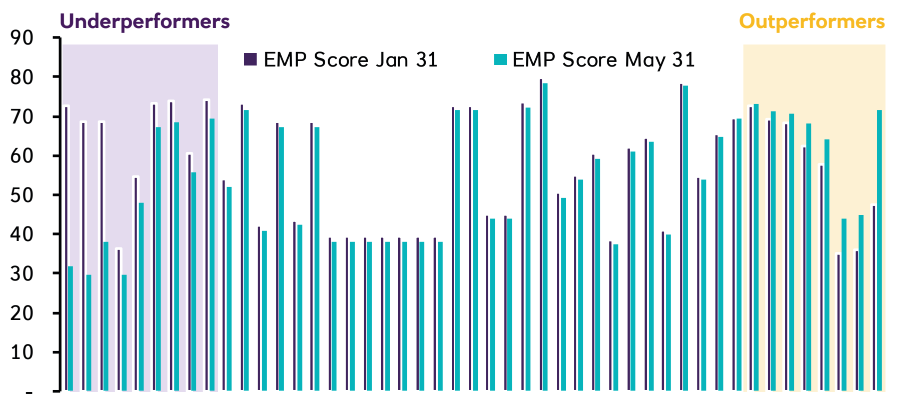
Evaluating working conditions and workplace-related health and safety performance specifically

Within Arabesque S-Ray's quantitative metrics are further "feature" scores that go deeper into each category. Within Social, we used these to drill further into the initial question posed: "how did companies fare in holding up their end of the social contract with their workforce, during a historic pandemic and performing a clearly essential service to the population? And did investors take notice?"

We examined two features that were directly related to our question: "Occupational Health and Safety: Workplace-related health and safety performance", and "Employment Quality: Working conditions and employee satisfaction." Given the type of issues being raised in the industry, these specific metrics are particularly relevant as they deal with the increasing concerns among some consumers and investors. We also limited the analysis to market cap weighted performance and scores to avoid any size sample bias.

Chart 2: There was even wider dispersion on employment quality indictor S Arabesque scores in Jan 31 and May 31

Source: Arabeque S-Ray and NWM Strategy



The results here are clear: companies that performed poorly in these two working condition metrics greatly underperformed both the wider PBJ index, and for Employment quality, their peers within the analysis group. Once again, even within these specific features with the overall ESG-Social sub-score, investors punished laggards.

This is particularly telling during a period when food demand increased significantly – there was a strong discrimination between companies and the correlation of workers' safety is strong. Investors also appeared to reward the best performing companies: the best performers in Employment Quality outperformed the PBJ ETF (though returns for Employment Quality were about the same as the benchmark group), while for Occupational Health and Safety metric, the outperformance is stark.

Table 4: Weighted Average Score Change and Equity Performance (by Market Cap), 1/31/20-5/31/20

Source: Arabeqsue S-Ray, Bloomberg, NatWest Markets

	Employment Quality		Occupational Health and Safety	
	Feature Score	Equity	Feature Score	Equity
Worst Performers	-15.9%	-17.9%	-20.1%	-9.6%
PBJ ETF	-	-4.3%	-	-4.3%
Benchmark group	-1.9%	1.2%	-1.9%	-5.8%
Best Performers	8.7%	-2.6%	20.1%	6.2%

These results highlight the importance of specific ESG considerations for investment decisions. This appears to especially be the case of late on the Social side, as NatWest Markets observed in a recent article "Coronavirus ESG series: The impact and outlook for corporates".

And as the availability and quality of granular data on factors such as occupational safety continues to improve, their role in investment allocations will grow. This is unquestionably a long-term phenomenon. The role of NGOs, consumer groups, and officials is also gaining importance, as they shape the public discussion and ultimately consumers' and investors' choices. By the same token, it raises the stakes for individual companies to improve their disclosures and actual practices, as they are increasingly scrutinized along these factors.

The bottom line is that ESG investing, in our view, is not simply about avoiding particular sectors vs others, it's about the growing role of these increasingly specific factors for companies across industries.

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