

ESG in the Beverage Industry

Heineken: A Case Study

With environmental, social and governance (ESG) factors increasingly getting investors' attention, major companies around the world have set aggressive carbon emission reduction targets. These targets, and the pathways to achieve them, will collectively have meaningful implications across every sector of the economy. We look at a case study of how a well-known beverage company is tackling emission reduction.

BACKGROUND

Major global consumer brands increasingly recognize they must reduce carbon emissions because, among other reasons, the reputational risk of not doing so is high. For most companies, achieving emission reduction targets is likely to translate into higher costs. For others, like companies which supply emission reduction solutions, the global move to cutting greenhouse (GHG) gases presents an opportunity for incremental revenues.

At Foyston, Gordon & Payne (FGP), we incorporate potential ESG risks and opportunities into our analysis of a business to understand the broader implications on company profitability. We typically engage with management teams multiple times each year, and these engagements have increasingly focused on initiatives related to ESG, a clear a priority for these companies.

From a financial perspective, we are likely to see stronger brands recoup some of the higher costs related to emission reductions by increasing prices, while brands with less strength will likely have to absorb these costs in their operating margins. Our goal, as always, is to have a portfolio of high-quality companies that can generate above average earnings growth at valuations that are more attractive than the general market.

Consumer Staples

The FGP International Equity strategy has had an overweight position in the consumer staples sector for the past several years. Companies in this sector, like many targeting consumers, have historically had good pricing power as a result of the strong relationship consumers have with their respective brands. Part of this relationship comes from the perceived quality of the products while a portion comes from an emotional connection to the brands. Companies invest significant amounts of capital in building and protecting their brands and in developing their customer loyalty.

Beverages

Almost half our consumer staples exposure is invested in three companies in the beverage sector - **Heineken Holding NV**, majority owner of Heineken NV ("Heineken"), **Britvic PLC**, and **Suntory Beverage & Food Ltd**. Heineken and Britvic have been in the FGP International Equity portfolio since 2016 while Suntory entered the portfolio in 2019.

We like the beverage industry from an investment perspective because the industry's products are low priced, consumable items, that are purchased on a regular and recurring basis. Given that the majority of what these companies are shipping has a low price-to-weight ratio, logistical infrastructure is important, as are bottling and manufacturing operations where scale can become a competitive differentiator. The companies in which we invest differentiate their businesses by investing in manufacturing, distribution, and brand marketing to maintain and grow leading market share positions.

Setting Targets

All three companies have established emission reduction targets, most of which have been verified and confirmed by the SBTi, short for the Science Based Targets initiative. (See the sidebar on the next page for more details on how the SBTi works.) These targets focus on reducing or eliminating emissions in the next few years, as shown in the accompanying table on the next page.

While these companies have set aggressive Scope 1 and 2 targets, the overwhelming majority of emissions are generated across the broader value chain, known as Scope 3. These three companies have all set long-term Scope 3 reduction plans because starting to address Scope 3 now is critical to achieving their emission reduction goals. (Read more about the differences between Scopes 1, 2, and 3 in the sidebar on page 4.)

Medium-Term CO2 Emission Reduction Targets

Type of Emissions	Heineken 2030 Targets	Britvic 2025 Targets	Suntory 2030 Targets
Scope 1	100%	50%	50%
Scope 2	100%	50%	30%
Scope 3	21%	35%	--

Source: Company reports

HEINEKEN: A CASE STUDY

Heineken, the fourth largest beverage company in the world, is one of the most carbon intensive holdings in the FGP International Equity portfolio. The size of the Scope 1 and 2 emissions that have been disclosed by the company is 1.6 MT CO₂E based on its 2018 production footprint. Scope 3 emissions, at 19.5 MT CO₂E, are 12 times larger. While Heineken aims to eliminate its Scope 1 and 2 emissions by 2030, the company is targeting net zero across the full value chain – Scopes 1, 2, and 3 - by 2040, a full decade ahead of the Paris Agreement's 2050 goal.

These targets are ambitious considering the size and reach of an organization like Heineken, with €25 billion of sales generated by 82,000 employees in over 70 countries and 166 production sites. The SBTi has yet to confirm Heineken's Scope 3 targets due to a significant backlog of corporations attempting to get their Scope 1 and 2 targets confirmed.

Heineken has provided good detail on where the bigger areas of carbon emissions are occurring across the value chain, and it has laid out specific plans to address the various categories. In several components of the value chain, such as malting (processing/brewing) and logistics, the company has a mix of both internal operations, partners, and suppliers that generate the emissions. Heineken employs dedicated teams across each of the categories in the accompanying diagram to develop and execute on strategies to achieve net zero for the overall company.

Heineken's Plans to Reduce Carbon Emissions Across the Value Chain

Agriculture (23% of emissions)

Grains are a key input into the production of beer and are the second largest source of emissions across the Heineken value chain.

This category includes the emissions from preparing land for cultivation and from harvesting the crop. The task at hand to reduce emissions in this category is immense and involves an almost complete rethink of the global food system. Companies like Heineken are taking steps to find solutions.

The Cool Farm Alliance, of which Heineken and many other global consumer companies are members, has a tool - the Cool Farm Tool- that helps farmers, at no charge, calculate their farms' carbon emissions. Heineken has developed a Low Carbon Farming Program where it is working with 500 pilot farms to test new farming practices. With the Cool Farm Tool, the farms are inputting the relevant data and monitoring their progress over multiple years. The idea is to test various initiatives (e.g., less

The SBTi and its Approval Process

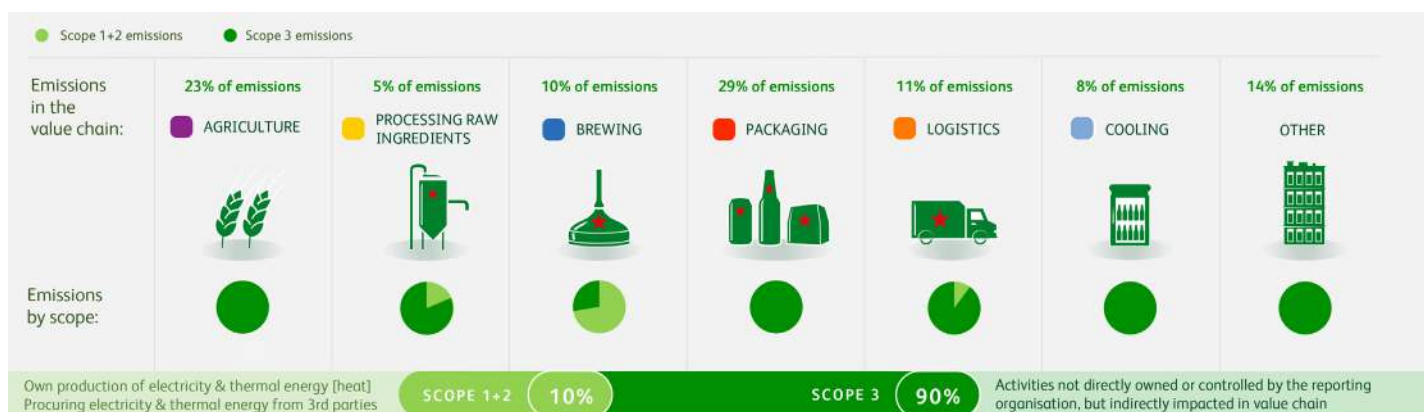
The Science Based Targets initiative (SBTi) is increasingly becoming the standard by which companies are measured with respect to their carbon reduction goals. The SBTi is a partnership between the CDP (founded as the Carbon Disclosure Project), the UN Global Compact, the World Resources Institute (WRI), and the World Wide Fund for Nature (WWF). The SBTi's goal is to drive ambitious climate action in the private sector by enabling organizations to set science-based, rather than aspirational, emissions targets in line with what is deemed necessary to meet the goals of the Paris Agreement – limiting global warming to well below 2°C above pre-industrial levels while pursuing efforts to limit warming to only 1.5°C. The SBTi clarifies the quantity and the speed in which companies need to reduce their GHG emissions in order to reach these targets.

Companies wishing to join the SBTi must follow a five-step process.

- Companies submit a letter establishing their intent to set a science-based target. They then have 24 months to submit their targets.
- They work on setting emission reduction targets consistent with the SBTi's criteria.
- Companies present their targets to the SBTi for official validation.
- Once approved, companies must communicate the targets to all stakeholders.
- They must then report, on an annual basis, company-wide emissions, and the progress against their targets.

Companies must establish science-based targets that cover Scope 1 and 2 emissions, and calculate the emissions associated with Scope 3. For companies whose Scope 3 covers more than 40% of their combined Scopes 1, 2 and 3 emissions, targets must also cover Scope 3.

Heineken's Estimated Full Value Chain Carbon Footprint



Source: Heineken 2021 Presentation "on path to net zero"

fertilizer, regenerative/conservation agriculture techniques, etc.) and track on an annual basis the reduction of carbon emissions. Heineken plans to bring more farms into the program in the near term and, by 2027, expand the most successful approaches to the much broader farming community. The company's target is to get adoption from over 10,000 farmers. Heineken's raw material processing partners are expected to play an important role in helping scale these projects within the broader farming community.

Processing Raw Materials (5% of emissions)

The majority (90%) of the raw material processing (malting) for Heineken is done by suppliers. The key area of focus for both internal and external malting production is to switch the energy consumption in this process to renewable solutions. The 10 malting plants that Heineken owns directly are all expected to be using 100% renewable energy sources by 2030.

Brewing (10% of emissions)

Brewing is where the bulk of the Scope 1 and 2 emissions are generated. By 2030, the company aims to eliminate the carbon footprint of its 166 brewing sites around the world. The first step is to reduce energy consumption by standardizing best practices across all brewing sites, potentially reducing the network's energy consumption by 20%. Heineken would meet its remaining energy needs by using renewable sources.

Heineken needs to address two specific areas of energy consumption: electricity and thermal. Electricity consumption is relatively more straightforward from a solutions perspective. The company aims to build new on-site generating capacity to supply electricity from wind, solar and hydro power, and to sign long-term procurement agreements (PPA), ranging from 10 to 15 years, with the operators of these new electricity sources. A key distinction is that Heineken wants the sourcing to come from incremental projects, rather than existing projects, to help support the broader development of renewable energy sources.

Thermal energy from sources such as natural gas and coal now represents 60% to 70% of the carbon emissions in the brewing process, which requires high temperatures. This conversion of thermal energy to more sustainable sources, at the scale required for these types of operations, is far more challenging than the conversion of electricity. There are fewer viable options currently available, and the company is using a more regional approach to best match the various options that are available. Renewable thermal technologies include biogas, biomass, waste-to-energy, geothermal, and solar thermal. Heineken has found some innovative regional solutions like using biomass from rice husks to generate energy in Vietnam, but fully acknowledges that these are not viable longer-term solutions on a global scale. Sustainable thermal energy solutions are challenging for several industries, especially those that require extremely high temperatures. Heineken is optimistic that, given its requirements for lower temperature thermal energy, renewable electrical solutions will become available.

Logistics (11% of emissions)

Approximately 95% of logistics are outsourced. Heineken has a new fuel management project underway where suppliers are using telematics systems to promote safe and fuel-efficient driving, with the data getting reported regularly. The key focus initially is the 17 markets that represent over 80% of logistics-related emissions.

Cooling (8% of emissions)

The strategy with respect to cooling is to reduce and replace. Sales teams within Heineken are working with customers such as retailers and bars to replace existing coolers with more energy efficient coolers. These teams are also working to better understand the needs of customers with respect to cooling. In addition, the company has set up recycling efforts to remove salvageable parts from older legacy systems and integrate those back into new, more energy-efficient coolers.

Packaging (29% of emissions)

Packaging is the largest area of emissions for Heineken and is a clear area of focus for the company and FGP because it represents close to 30% of the emissions generated across the full value chain. Making progress in this area is critical to achieving the company's longer term reduction targets.

The firm's strategy is focused on reducing and reusing packaging and is looking to address all aspects of packaging from glass bottles to plastic cups that get used at events where Heineken is served. A big concept behind improving the environmental impact of packaging is the idea of a circular economy where items like glass bottles can find their way back to the brewer. Establishing the circular infrastructure is a complex process and has been one of the limiting factors on increasing returnability. Heineken estimates that less than 50% of the glass the company uses for its beer gets returned for re-use. Bottles typically can be re-used 20 to 30 times. Aluminum, Heineken's second largest type of packaging, has a far greater re-usability as the material can be re-used an almost infinite number of times. Heineken continues to actively engage with stakeholders at a country level to establish the required infrastructure. We, in turn, are actively engaging with Heineken on the need for them to create and disclose circularity targets with respect to packaging.

Packaging innovations like the "green grip", made of 100% plastic-free cardboard, have been rolled out in the U.K. to replace traditional six-pack plastic ring toppers for multipacks of cans. This change required upfront investment on the bottling lines to switch over to the new packaging, which will save 500 tonnes of plastic each year in the U.K. These packaging changes have been rolled out more broadly and can be found in other countries, including Canada.

Defining the Scopes

- Scope 1: Emissions generated from sources that a company owns or controls, such as a company's own operation.
- Scope 2: Emissions generated indirectly by the consumption of purchased electricity, heat, or steam.
- Scope 3: Emissions generated across the value chain.

For the beverage industry, Scopes 1 and 2 cover the emissions from the process of manufacturing the product, and, in situations where the company owns the means of distribution, getting it to market. Comparisons across companies can get distorted since a company that delivers its product to market in another company's trucks will have lower Scope 1 and 2 emissions than a beverage company using its own trucks. A Scope 1+2+3 comparison is more meaningful because it includes the emissions from sourcing the key ingredients through to the impact of packaging and distributing the products.

Regrettably, the limited disclosure of Scope 3 emissions – some companies calculate them, some don't – is a challenge for the investment industry in achieving accurate comparability across businesses. Even for those companies which do calculate Scope 3, some emissions are not included – for example, the emissions from the cooling of beverages in customers' homes and the emissions from employees commuting to work.

Our Analysis of Heineken's Actions

We commend Heineken for the goals they have set and their initiative to take the leadership role to achieve their emission-related ambitions by 2040. The emission reduction targets will require a massive amount of infrastructure change over the next 15 years for Heineken and all companies along the full value chain since Heineken's Scope 3 emissions are other firms' Scope 1 and 2 emissions.

Heineken's management compensation is being aligned with the company's emission reduction goals. Starting in 2022, management's long-term incentive (LTI) compensation is tied to performance across four equally weighted measures: organic revenue growth, EPS growth, free cash flow performance, and ESG, which replaces operating profit growth. The key performance indicators (KPIs) of the ESG component are related to carbon emission reduction, water efficiency, and the percentage of women in senior level roles.

We strongly believe that compensation aligns incentives and drives outcomes, so we expect Heineken will allocate internal resources to achieve its ESG-related goals. We also expect a higher degree of investment related to these ambitions, and, as a result, higher costs. While management has been reluctant to share its estimate of the investment required to achieve these targets, we will continue to engage with Heineken regularly and assess incremental information as it becomes available.

CONCLUSION

We are pleased by the ambitious targets being set by the companies in the portfolios we manage. With management compensation increasingly tied to achieving these targets, there is a far greater chance of success. At the same time, as investors, we need to continue to engage with the management teams to track progress and attempt to accurately account for the costs they are likely to incur to support this transition. The core principle of our investment process is to own a portfolio of high-quality companies that can grow earnings faster than the market, at a valuation that is cheaper than the market. The transition to a net-zero world is very positive for society and the environment and we will continue to encourage and track management progress while also being diligent to incorporate the expected costs into our analysis and valuations.

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