Key risks facing the beverage industry

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We all know that water is the essential ingredient in a beverage product, as well as vital for cooling and cleaning during the production process. So when one considers that India's current water supply is approximately 740 billion m3, but it has been estimated that by 2030 demand for water in India will grow to almost 1.5 trillion m3, the industry will clearly be facing a major problem there. There will simply not be enough water.

The same could be said for China and the rest of Asia in fact. In China, changes in seasonal weather patterns have resulted in severe water shortages in parts of the country, such as the Yunnan province, which is experiencing the worst drought in 100 years. Furthermore, 75 percent of rivers flowing through urban areas are now considered unsafe for drinking or fishing.

Yet China, India and Indonesia are all a focus for beverage companies due to their lower market penetration. There can be little doubt, however, that water security issues will be one of the biggest threats to developing market potential.

These are the kinds of issues that are reviewed in a recent report published by Responsible Research titled Beverages in Asia: Issues for Responsible Investors. The report is a useful resource for anyone with an interest in the key Environment, Social and Governance (ESG) risks affecting listed companies in Asia producing both alcoholic and non-alcoholic beverages and it uses a series of corporate case studies to reflect these. The report also goes on to share benchmarking results of leading Asian listed companies in the sector on sustainability indicators and their performance rated against five global players. The report is the latest in a series of sector specific reports produced by Responsible Research for the investment community.

There are clearly a host of sustainability challenges facing the industry, but what I found particularly interesting was reading about the scale of growth of the industry in Asia.

Let's first take a look at the alcoholic drinks industry. The market growth for alcoholic drinks is particularly strong in emerging Asian economies, driven by a range of socio-economic factors. These include favourable demographics such as the greater proportion of young people reaching the legal drinking age and increased per capita income and urbanisation in countries such as India and China. A larger middle class directs funds to aspirational purchases. While Guinness and Carlsberg remain household names, the marketplace has become dominated by local tastes and brands.

In the spirits sector, India's United Spirits overtook Paris based Pernod Ricard to become the second largest spirits company in the world earlier this year. The Indian company is now looking to expand in countries similar to its home market such as Sri Lanka, Vietnam, Cambodia and Singapore by buying up distilleries. Africa is also part of its expansion plan.

The report points out that people in countries such as India, China, Philippines and Vietnam are consuming volumes of alcoholic and soft drinks at rates far exceeding developed markets. In Vietnam alone, these industries formed 25 percent of GDP in 2008.

The water bottles market is also booming. Danone, Nestlé, Coca-Cola and PepsiCo all have significant water businesses in developing countries. The report predicts that as the market develops, a frenzy of mergers could reshape the landscape and new Nestlés and Coca-Colas will emerge from Asia as dominant players.

The market for bottled water is developing rapidly in Asia. Health concerns of polluted municipal water sources and increasing water shortages are expected to be key drivers of this, but wealth and the increase in Asian middle classes will play the most significant role. Consumer demand for purity, hygiene and convenience is on the increase.

Country	Company	Products	Market Share
India	United Spirits	Spirits	23%
India	United Breweries	Beer	20%
Philippines	San Miguel	Beer	77%
Malaysia	Guinness Anchor Berhad	Beer & Stout	57%
Vietnam	Saigon Alcohol and Beverages Corporation	Beer	31%
China	China Resources Enterprise	Beer	17%

Figure 1: Market Share of Leading Drinks Companies <http://www.csr-asia.com/upload/Image/14_s.jpg>

In India the market is expected to grow by 100 percent over the next five years and there are currently more than 2,000 bottled water producers. Whilst there has been a backlash against bottled water in developed countries as the environmental impact of plastic bottles becomes more apparent, in Asia it looks set to become an increasing trend.

In the face of all this growth, there are clearly a host of environmental and social issues that beverage companies would be well advised to take note of. Responsible Research's report provides a detailed outline of these key concerns.

Key environmental issues

The key environmental consideration of the bottling, brewing and beverage industries is to be less dependent on finite resources such as fresh water, fossil fuels and other natural raw ingredients. But water issues form the predominant focus of the report, which makes sense as water is the primary resource for the industry. The beverage industry is particularly exposed to water risk because a) it is dependent on large quantities of water for production and b) a large proportion of this water needs to be very high quality for production. So in all, the portion of water available to these companies is limited.

The key water challenges facing the industry include efficiency improvements (using less quantity of water per product); maintaining access to high quality water; and dealing with wastewater from the production process.

Another environmental consideration is climate change and how far along the industry has come in terms of managing the production of greenhouse gas emissions and conserving energy. Beyond mitigation, climate change is also likely to further exacerbate water scarcity issues in the region through changing rainfall patterns.

Sustainable agriculture, in particular the link between the price of raw materials and the availability of water for irrigation, is an issue which the industry cannot afford to ignore. Sugar is often the most important ingredient in many drinks and reduced yields would pose a clear threat to the operations of Asian and global companies.

Other environmental issues to be aware of are associated with the transport of goods, from manufacturing plants to distribution centres, wholesaler locations and beyond. Considerations around sustainable packaging and minimising waste are also increasing in concern as consumer perceptions develop in certain markets. Although sustainable packaging is not yet a primary motivator of purchases, it is increasingly expected by consumers, particularly in western markets.

The report also takes a look at supply chain complexity in general and points out that the sheer number of suppliers complicates the supply chain in the Asian beverage industry, making these environmental issues even more difficult to deal with.

The report finds that leaders on water performance and transparency tend to be those companies linked or owned by a large multinational company. In these cases, subsidiaries often rely on the reporting structure of the global website and global sustainability report.

Name	Main product	Country	Environment Report
Nestlé India	Soft drinks	India	Creating Shared Value Report – only global report available.
United Breweries	Beer	India	CSR section on web site.
China Huiyuan Juice	Fruit and vegetable Juice	Hong Kong	None.
Tingyi	Bottled water / RTD tea	Hong Kong	None.
Tsingtao Brewery	Beer	Hong Kong	None.
UniPresident	Dairy	Hong Kong	CSR section on web site.
Vitasoy	Soy products	Hong Kong	None.
Multi Bintang	Beer	Indonesia	CSR section on web site.
Fraser & Neave	Soft drinks	Malaysia	CSR section on web site with Environment sub-section
Thai Beverage	Beer	Thailand (Sing listing)	None.
Vinamilk	Dairy	Vietnam	None.

Figure 2: Water Followers in Asia <http://www.csr-asia.com/upload/Image/37_s.jpg>

In terms of climate change of the 30 benchmarked companies, the majority, (17 in total) make no comment on climate change related initiatives or acknowledge its importance as an issue. Despite this lack of strategic direction and reporting, some beverage companies are starting to put in place some very interesting initiatives. Carlsberg Brewery Malay Berhad, Thai Beverages and GAB are all developing alternate energy sources whereby the companies have utilized the production of biogas during the treatment of waste water effluent as an energy source. Other production by-products are being used in different beverage production facilities in the case of SABMiller India with rice husks and Tata Tea with tea waste.

Key social issues

For the alcohol industry the social concerns are numerous, ranging from associated disease as well as health and safety impacts from high levels of alcohol consumption, to under-age drinking, and in developing country contexts the portion of spending on alcohol versus basic needs. Domestic violence and an exacerbation of poverty have made alcohol abuse the single most important problem for women in India. The report points out that as prosperity levels increase across Asia, we can expect to see increasing levels of alcohol consumption. This presents both an opportunity for listed companies in Asia, but given the potential negative social impacts, it also presents significant challenges.

In Malaysia, a WHO report from 2004 highlighted that the biggest victims of alcohol are the poor, particularly rural labourers who work in rubber and oil palm estates. In those areas, cheap alcoholic drinks such as Samsu (a locally distilled potent spirit with an alcohol content of between 37 and 70 percent) are a major factor in exacerbating poverty.

Alcohol companies, in particular, are having to proactively approach and engage with regional governments in order to stay ahead of legislation on labeling and marketing of alcohol. Companies are also challenged to keep ahead of changing taxation levels and laws across a range of geographies, which sometimes have the effect of fueling illegal markets. These are a particular challenge as they tend to remain unmonitored for quality and safety. The report shows that according to Vietnamese trade sources, 80 to 90 percent of spirits sold in the market are counterfeit. In Indonesia the size of the black market has been estimated to be equivalent to 60 percent of all alcohol consumed.

Government regulation in itself is not always able to control or curtail alcohol abuse, and global beverage companies are encouraged to expand self-regulation and co-regulation in countries with little or no restrictions over marketing practices. Social marketing, whereby the industry itself promotes moderate drinking for adults and abstinence for minors, has been practiced by some MNCs, but is generally lacking with local listed companies across developing Asia. Developing detailed product responsibility policies and investing in consumer and employee education is important in Asia.

One issue that the report highlights as a clear reputational risk for brewers is the use of beer girls in Asia, who are often faced with dangerous working conditions such as harassment or sexual exploitation. In 2006 major brewers operating in Cambodia, came together to establish the professional industry organisation “Beer Selling Industry Cambodia” (BSIC). Participating brewers include Asia Pacific Breweries, Cambodia Brewery Limited, Cambrew Ltd., Carlsberg, Guinness and Heineken. BSIC aims to improve the health, safety and working conditions of beer promoters by setting industry standards.

For soft drink makers, stakeholder engagement will become an important focus as health issues mount relating to sugar intake and the use of artificial ingredients become increasingly common. Soft drinks, including juices, sodas, ready-to-drink teas, sports and energy drinks are becoming increasingly popular throughout Asia. Compared to leading global soft drinks brands, the social impacts of soft drinks are not well covered by Asian companies, including dietary or obesity related issues. As the report points out this may be because the priority for Asian soft drink companies is to meet growing consumer demand rather than responding to less vocalised health concerns.

Yet, signs of innovation are emerging as in the case of PureCircle Sdn Bhd in Malaysia, which has developed a method of naturally extracting Rebaudioside-A from the Stevia plant (a plant native to Paraguay) to produce a substance, which tastes very similar to sugar but is 200 times sweeter. But again this is being led by MNCs such as PepsiCo, Coca-Cola and Unilever.

Health and safety issues along the supply chain remain an important issue for all beverage products. The more complex and fragmented the supply chain, the less control a company has on production and the potential for problems relating to quality, safety and human rights abuses. A classic example of where quality and safety control issues can pose a serious risk to consumers and to the reputation of businesses is in the case of the food safety scandals from the Chinese dairy industry in 2008.

The report points out that labour issues will continue to be an issue for large multinational companies (MNCs) operating in emerging Asia. This is particularly true of breweries in developing countries, as they use a great range and volume of raw materials derived from agricultural processes (wheat, hops and barley) and often rely on these from a large number of small holding farmers. The issue of casual labour and lack of rights to labour union membership, annual and medical leave and lower wages is a big concern for the industry in general.

Key governance issues

A typical challenge in the Asian beverage sector’s fight against corruption is the complex interrelationship between politics and the private sector. Strong governance is clearly vital for companies to ensure the integrity of their organizations, relationships with consumers and government authorities to avoid corrupt business practices.

All 30 benchmarked companies have strong governance scores and the report points out that this is predominantly linked to the requirements of stock exchanges on which the companies are listed. Yet one problem area noted was that few of the Asian listed companies have boards with a majority of independent directors. While Asian companies understand the value of having independent board members, implementation remains slow. Furthermore, the information provided on board members in Asia varies significantly and evaluating a director's experience is challenging. Other concerns include vague information about the board re-election process, transparency around board remuneration and performance related pay, and particularly in the case of alcohol companies – lack of transparency of providing financial support for industry groups that lobby national governments for changes in alcohol policies.

Reading the report it very quickly becomes apparent that beverage companies operating in Asia face many ESG issues which will have a material effect on the bottom line. But there are policies, processes and tools that companies can put in place to minimize these. I have included below recommend steps for starters and look forward to reading about the developments in this industry in the years to come:

On the environmental side:

1. Companies need to first assess to what extent they and their suppliers depend on water and the associated risks. This should be done in consultation with key stakeholders

2. Companies should measure their water footprint and look to how they can best manage water resources through enhanced processes and infrastructure

3. Companies should implement rigorous water testing and monitoring systems and install treating equipment. Water pollution and treatment is already a focus of Asian listed companies and with the growing emphasis on regulation and enforcement this looks set to increase

4. Companies need to realize that global commitments to improve water efficiency can only be implemented locally, requiring versatility and local management support

5. Companies should disclose water performance and the initiatives that they are putting in place

6. Companies need to assess their contribution to climate change, put in place measures to reduce emissions and waste and report on progress

On social issues:

7. Soft drink companies are advised to anticipate government regulations, particularly in relation to their marketing approaches to children

8. Companies need to be innovative in creating healthier soft drink products as in the case of PepsiCo and Coca Cola focusing on a low sugar, natural sweetner for their products and Vietnamese and Chinese brands tapping into the demand for alternatives to carbonated soft drinks

9. For alcohol beverage companies engagement of all stakeholders is key to managing social issues and the strategies relating to drinking. This includes the engagement of consumers, employees and the community

10. Companies should assess their supply chain risks and put in place codes of conduct, monitoring and capacity building initiatives to prevent these. As consumers become more aware of supply chain issues, good supply chain management can create a competitive advantage

11. Companies that rely on agricultural supply chains, particularly large numbers of small holding farmers, should look to developing partnerships with government, local NGOs and international agencies to better manage social risks

Issues related to governance:

12. Companies should look to providing more transparency and accountability in terms of the selection of board members, remuneration, links between remuneration and performance, diversity of the board and decision making processes

13. Alcohol companies should ensure a high level of transparency in terms of the financial support provided for industry groups that in turn lobby national governments for changes in alcohol policies

14. Companies should put in place initiatives and get involved in collective action to raise corporate integrity, especially in relation to corruption and bribery

The report can be downloaded from the Responsible Research website.

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