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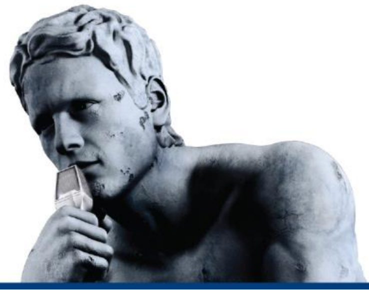

Schroders
TalkingPoint

Water stress: The rising costs faced by beverages companies

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In the wake of rising company awareness and the increasing costs of water risk, we explore the potential financial impacts of water stress on companies in the beverages sector.

Water scarcity has been widely discussed across different sectors but has often been viewed as a long-term sector risk - something that is just beyond the investment horizon. However, the CDP (formerly the Carbon Disclosure Project) water survey shows that the majority of companies across all sectors believe that water risks will materialise within the next three years[1]. This places water risk firmly within the investment horizon.

Water stress: increasing pressure on supply and demand

What is causing this water stress and how does it translate into risk for companies? According to the World Resource Institute: "*Water stress measures the ratio of total water withdrawals in a catchment in a given year (the sum of domestic, industrial, and agricultural) to the total available water (the amount available in the same catchment averaged over a long time period)[2].*"

While 71% of the earth's surface is covered in water[3], only 0.6%[4] of this is water available for consumption by people and business and the supply of clean, fresh water is decreasing. At the same time, there is an increasing demand for water through agriculture, a growing global population and economic development. Supply side and demand side pressure means that water is increasingly becoming a material risk for companies that are struggling to source scarce, clean water. In our view, understanding and managing water risk may be fundamental to a company's ability to continue as a going concern.

The rising cost of a licence to operate

We believe that as the awareness of water risk from all stakeholders improves, the regulatory burden on companies and their suppliers will increase. This, in turn will push up the cost of operating licences for various businesses.

However, complying with the regulations should be the minimum standard. Companies also need to attain a social licence to operate. Water management is no longer about just the environmental risks, such as avoiding water pollution and maintaining water quality – it is also about broader social risk. Water availability is important in terms of human rights (access to clean drinking water), agriculture (the reliance on water for livelihood) and is a vital source for companies supporting economic development.

Failing to secure a social licence to operate in water stressed regions can result in a material cost to businesses. For example, the Coca-Cola Company decided not to move forward on the development of an $81 million bottling plant in southern India in April 2015 due to resistance from local farmers who cited concerns about strains on local groundwater supplies. Many food producers and beverages companies are spending increasing amounts supporting initiatives to provide clean drinking water to local communities as a way to maintain their licence to operate. These community costs are on top of the increased financial burden

[1] CDP, Global Water Report, 2015
[2] Integrating Water Stress into Corporate Bond Credit Analysis, BMZ, September 2015
[3] National Oceanic and Atmospheric Administration, http://www.noaa.gov/ocean.html, November 2015
[4] Schroders, ESG research: Water – Cheap and abundant, but not for long, R. Stathers, December 2007

of complying with regulation.

Sector focus: Water risk for beverages companies

The beverages sector is highly dependent on water for both direct operations and along the supply chain through sourcing agricultural commodities. Of the 36 global beverage companies responding to the CDP water survey in 2015, over 90% evaluated water quality over the next 10 years as a driver to the success of their long-term strategy[5]. The brewing sub sector is particularly vulnerable to changes in regulations and increasing water-related costs. Along with soft drinks, it has the highest absolute volumes of water consumption. Our analysis shows this exposure is already driving up costs, with brewers reporting the biggest increase in water-related capital spending (as defined by CDP).

We conducted analysis of the brewing companies held by Schroders. From our research, we conclude that most brewing companies have adequate water management practices to help them identify water risk at the local level. However, evidence that firms are mitigating the impact of identified local water stress, is less clear. The analysis also revealed that compared to other beverages sub-sectors, brewers are failing to engage with local communities; other sectors provide access to water, support local agriculture and collaborate with local partners and non-governmental organisations (NGOs).

Overall, these two factors may expose companies to greater pressure on margins in the medium term. Greater exposure to water stressed regions will likely be reflected in greater operating spend in order to maintain operating licences while the need to invest in community-related projects will add to social operating costs.

Another trend we identified is that while many companies have good risk management systems in place, only one of the eight companies we analysed acknowledged water as fundamental to its business model and listed it within the firm’s principle risks in the annual report. Given that water is a key ingredient for all brewers, investors may be concerned by the lack of board oversight and failure to acknowledge this risk as fundamental to the business model.

Focus on improving water efficiency

Water stress is now recognised as a key issue by multiple stakeholders across sectors, from local communities to companies and regulators. In response to rising water costs, stricter regulation and pressure from local communities, companies should be focused on improving water efficiency from manufacturing and production in order to reduce operating and social costs.

[5] Schroders / CDP Analytics data 2015