

## FIXED INCOME

# Food Security Through an ESG Lens

July 19, 2019



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Consumers in emerging markets are demanding more meat. But with virulent animal diseases threatening some traditional sources of their meat proteins, they are having to look beyond their domestic and regional markets to sate the demand. In this article, Franklin Templeton's James McGiveran uses environmental, social and governance (ESG) analysis to uncover some wide-ranging implications for the global food sector.

As analysts, we spend much of our time assessing material issues that can affect the availability and price of food across the world. Those issues might be economic or political, but increasingly environmental, social and governance (ESG) factors are having an impact.

Food safety and security, for example, is an important ESG consideration in the context of meeting growing demand.

Changing global demographics and international supply chains, coupled with unpredictable global relationships, mean that small changes in one part of the world can have amplified effects elsewhere.

One of the most interesting considerations today is the impact that African swine fever (ASF) in China may have on the global supply of meat proteins.

## What Is ASF?

ASF is highly contagious, difficult to track and even more difficult to contain and eliminate. The disease is deadly to animals and no vaccine currently exists.

While the disease is concentrated in China, it has also appeared in Africa, Eastern Europe, Cambodia and Vietnam.

The most effective approach generally is to liquidate the affected herd and, potentially, the surrounding herds.

## China's Domestic Pork Supply Under Threat

China's domestic pork supply is currently facing a virulent strain of ASF.

Pork is the most consumed meat protein in China, and the country accounts for around 50% of the worldwide hog supply.

However, even with that size of domestic supply, China consumes nearly all of the meat that it produces and has no meaningful pork exports. Its imports have grown in proportion to the growth of its middle-class population.

China's regulators have not released official reports on the magnitude of this infection, but current estimates put the affected size from 10% to 30%. That would imply an impact of around 5% to 15% of the world's supply of pork, according to our analysis.

As a result, we expect China will have to import proteins to fill that gap left by ASF. Most of that will be pork. However, other proteins will also likely be used, such as beef and poultry.

Chinese imports of meat-based proteins spiked during the last major outbreak impacting livestock (avian influenza from 2015 to 2017) and the US Department of Agriculture now expects that China will have to increase imports of meat-based proteins by around 30% in 2019 to account for the impact of the ASF.

## **How Can China Sate Its Pork Appetite?**

It's unlikely that US pork supplies will fill the gaps left by China's domestic shortages.

As a result of the intense trade dispute with the United States, China is imposing a 62% tariff on imported US pork. We therefore expect China to turn to Brazil, the European Union (EU) and Australia for its protein supply.

But as those exporters redirect their wares, we still see an opportunity for the US meat protein industry, particularly poultry production, as it positions itself to step up exports to areas previously served by the EU and Brazil.

US hog prices have risen since early March 2019 on tightening global hog supplies. Poultry prices have moved higher as well.

As a consequence, we expect the US poultry industry to add around 10% to 12% processing capacity from 2018 to 2021.

## **Biosecurity as an ESG Concern**

The clearest and most effective method of dealing with biosecurity issues is prevention. Moreover, a failed response to an influenza outbreak would directly impact not only consumer health, but also the financial health of the companies involved.

It's illustrative to consider the response and outcomes during previous disease outbreaks to appreciate the importance of advanced biosecurity measures such as rapid identification and liquidations, as well as regulations, including rules on feeding, raising and husbandry.

During the last major global epidemic affecting poultry producers, the 2015–2017 outbreak of avian influenza, developed economies such as the United States and the EU were able to activate their biosecurity measures effectively.

Their authorities were in constant contact with farmers and their dedicated biosecurity laboratories and facilities and were able to identify and liquidate the affected flocks with minimal ancillary contagion. That isn't to say the impact of this outbreak wasn't meaningful; it was.

Approximately 10% of the total North American and EU poultry flocks were affected. Given the tight supply-demand environment, both at the farmer and the processor levels, egg prices, live chicken pricing and processed chicken prices went up meaningfully.

## **Brazil Offers a Comparison**

By contrast, the regulatory environment in Brazil—evaluated by just about any measure—is poor. The country lacks enough regulators to staff the facilities. For some time, the Brazilian government has relied on regulated companies to supply the headcount to effectively regulate themselves.

A food safety investigation into some of Brazil's largest meat processing companies that began in 2017 led to some large fines and lost international business.

While Brazil did eventually eradicate the 2015-2017 strain of avian flu from its flocks, we are not convinced the country's food regulation challenges have been entirely addressed and rectified. Looking at the situation in China today, with the example of Brazil at the front of our minds, gives little cause for optimism.

# A Bleak Outlook for China's Pork Production

Even with a regulatory regime almost universally recognized as poor, Brazilian producers were still able to eradicate the most recent avian flu outbreak.

In China, by contrast, the 2015-2017 strain of avian flu persists. So, we're looking at a situation in which a much more virulent disease affecting the world's largest pork market is being managed by a government that is still struggling to contain avian flu.

In our assessment of the material ESG factors, the combination of poor disclosure and limited oversight of family farms make it unlikely that China will eliminate the ASF anytime soon.

Many experts believe China will not be able to recover its lost pork production for at least five years.

Given the already tight supply and demand balance and the expectation for further demand growth, the prices for meat-based proteins in general and pork are expected to continue to increase over the next year.

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