



Varun Beverages:

Engagement commentary

Federated Hermes SDG Engagement Equity Fund
Q3 2024

**Federated
Hermes** 

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ENGAGEMENT COMMENTARY:

Varun Beverages

In a nutshell

Indian multinational Varun Beverages manufactures, bottles and distributes soft drinks and is one of the largest bottlers of PepsiCo's drinks in the world. The group's international presence is growing and includes Sri Lanka, Morocco, Zimbabwe and South Africa.

At a glance:

US\$23.5bn

Market capitalisation
(September 2024)

US\$1.9bn

Revenue (Financial year 2023)

Investment case

- Varun Beverages has delivered revenue growth of more than 20% per annum¹ over the past decade and has been cited as 'best international bottler' by PepsiCo. Its solid track record supports expectations of further success.
- Varun has grown markedly over the last few years, but its scope for expansion remains significant. Consumption of soft and carbonated drinks per capita is still very low in India
- Through the acquisition of new territories and entry into new categories, the addressable market for Varun continues to expand.

Theory of change

A raft of sustainability improvement opportunities can be found across Varun Beverages' operations.

In 2023, Varun Beverages sold 21.9 billion bottles of soft drinks – 70% of sales were carbonated soft drinks, 23% water and 7% non-carbonated drinks (such as fruit or dairy-based drinks)².

Packaging and littering and the Indian informal economy

1 No poverty	8 Decent work and economic growth	10 Reduced inequalities	12 Responsible consumption and production	14 Life below water
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Despite having a per capita rate of waste generation below the global average, India has high levels of mismanaged plastic waste and is the highest generator of plastic pollution emissions in the world³.



¹ Company reports

² Company reports/Presentation (calendar year 2023)

³ A local-to-global emissions inventory of macroplastic pollution, Cottom, J et al, September 2024

It is worth noting that PepsiCo – whose brands include Tropicana, Mountain Dew, 7UP and Pepsi – was the leading international brand polluter in India in 2023 (16% of all recorded plastics)⁴.

Within India, the largest generator of PET⁵ plastic waste is the beverage sector and the country's recycling rates are high by international standards.

Recycling in India typically starts with local waste collectors – colloquially known as ‘ragpickers’ – who make a hand-to-mouth living collecting discarded plastic waste and selling it to waste traders. The piles of waste are then separated and transported to recycling plants; the resultant dried plastic flakes is then sent in bulk to textile spinning units and are generally used to produce recycled polyester fibres.

In many regards, the informal plastic recycling sector in India contributes positively towards achieving the UN Sustainable Development Goals (SDGs)⁶. It generates employment for many people, reduces the use of raw materials, and diverts plastic waste from landfills and oceans. However, India's informal recycling network cannot absorb the enormity of the challenge at hand.

Moreover, the informal nature of India's recycling economy has led to concerns about safety and child labour and calls for improvements to work conditions and pay. In New Delhi, for example, there are 300,000 ragpickers, with another 300,000 in Mumbai, of which 120,000 are under the age of 14⁷.

Water usage – beverage production is thirsty work

The soft drinks sector is self-evidently a water-intensive industry – and India is among the most water-stressed countries in the world⁸. In 2023, 16% of Varun's production came from seven plants situated in ‘critical’ or ‘over-exploited’ zones⁹. The company has the potential to have a positive impact on local communities by adapting its production processes and investing in water rejuvenation projects.

Carbonated drinks and rising obesity

One in eight people worldwide were classified as living with obesity in 2022, according to the WHO, and the rates of obesity among children and adolescents is on the rise.

While the obesity stats for India pale in comparison with developed countries such as the United States, the trend is obviously worrying. Moreover, there is a strong evidential link between sugary drink consumption and obesity and type II diabetes¹⁰ – particularly in low and lower-middle income countries¹¹.

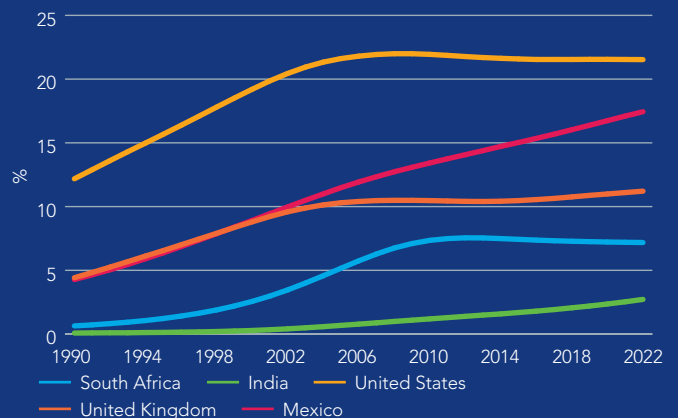


The sales of soft drinks in India are very low compared with most other countries.

In 2023, carbonated soft drink consumption in India stood at 5 litres per capita – compared with 9 litres per capita in China, 98 litres per capita in the United States and 133 litres per capita in Mexico¹².

This gap – in a country of 1.4 billion people – illustrates the scope of the commercial opportunity for Varun in the years ahead. It also provides pause for thought in terms of the potential impact on public health as consumption increases.

Figure 1: Prevalence of obesity among children and adolescents (10-19 years)¹³



Source: World Health Organisation.

⁴ Break Free From Plastic Brand-Audit 2023

⁵ **Polyethylene terephthalate (PET):** The most common thermoplastic polymer resin used in fibres for clothing, containers for liquids and foods, and thermoforming for manufacturing, and in combination with glass fibre for engineering resins.

⁶ **Sustainable Development Goals (SDGs):** The SDGs are a set of 17 interconnected goals that were adopted by all UN member states in 2015. They are a universal call to action to end poverty, protect the planet and improve the lives and prospects of everyone, everywhere, by 2030.

⁷ India's Ragpickers: An insight into circular economies? | Procurement Magazine

⁸ 25 Countries Face Extremely High Water Stress | World Resources Institute

⁹ Annual Report 2023 Varun Beverages Limited

¹⁰ The Nutrition Source, Harvard, 2024.

¹¹ Soft drink prices, sales, body mass index and diabetes: Evidence from a panel of low-, middle- and high-income countries, Goryakin et al, Food Policy, December 2017

¹² CLSA, Euromonitor, 2024

¹³ WHO, The Global Health Observatory, Prevalence of obesity among children and adolescents, BMI > +2 standard deviations above the median (crude estimate) (%)

Part of the answer may lie in artificial sweeteners – although concerns have been raised about the potential risks.

In 2023, the World Health Organisation (WHO) issued new guidelines on non-sugar sweeteners, advising against their use in efforts to control body weight. It also warned there may be potential undesirable effects, such as an increased risk of type 2 diabetes in adults¹⁴. However, the evidence with regard to beverages is less clear cut.

According to the Harvard School of Public Health, studies show that the consumption of artificially-sweetened beverages – at the expense of sugar-sweetened beverages – can lead to reduced weight gain over time, and can result in a 5% lower risk of cardiovascular disease¹⁵.

While this positive outcome is welcome, it is relative to an overall increased risk – compared with just avoiding such beverages altogether.

Practice of change

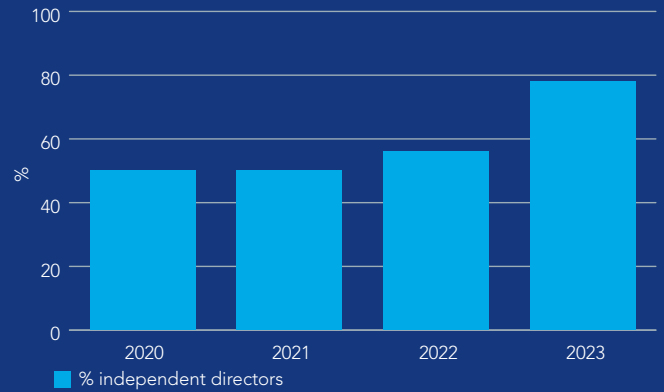
During our period of investment in Varun Beverages we have engaged with the company on various occasions to discuss the matters described above.

Governance and engagement

In terms of the ‘engagability’ of the business, we have been generally pleased at how receptive senior management has been. We had concerns at the outset about the company’s governance arrangements in light of its family-controlled structure.

- While we welcome the progress made to date, we continue to encourage the company to prioritise independence in future board appointments in order to: a) guard against perceptions that board independence is a secondary concern and, b) bring fresh perspectives to board discussions.

Figure 2: Varun Beverages board independence

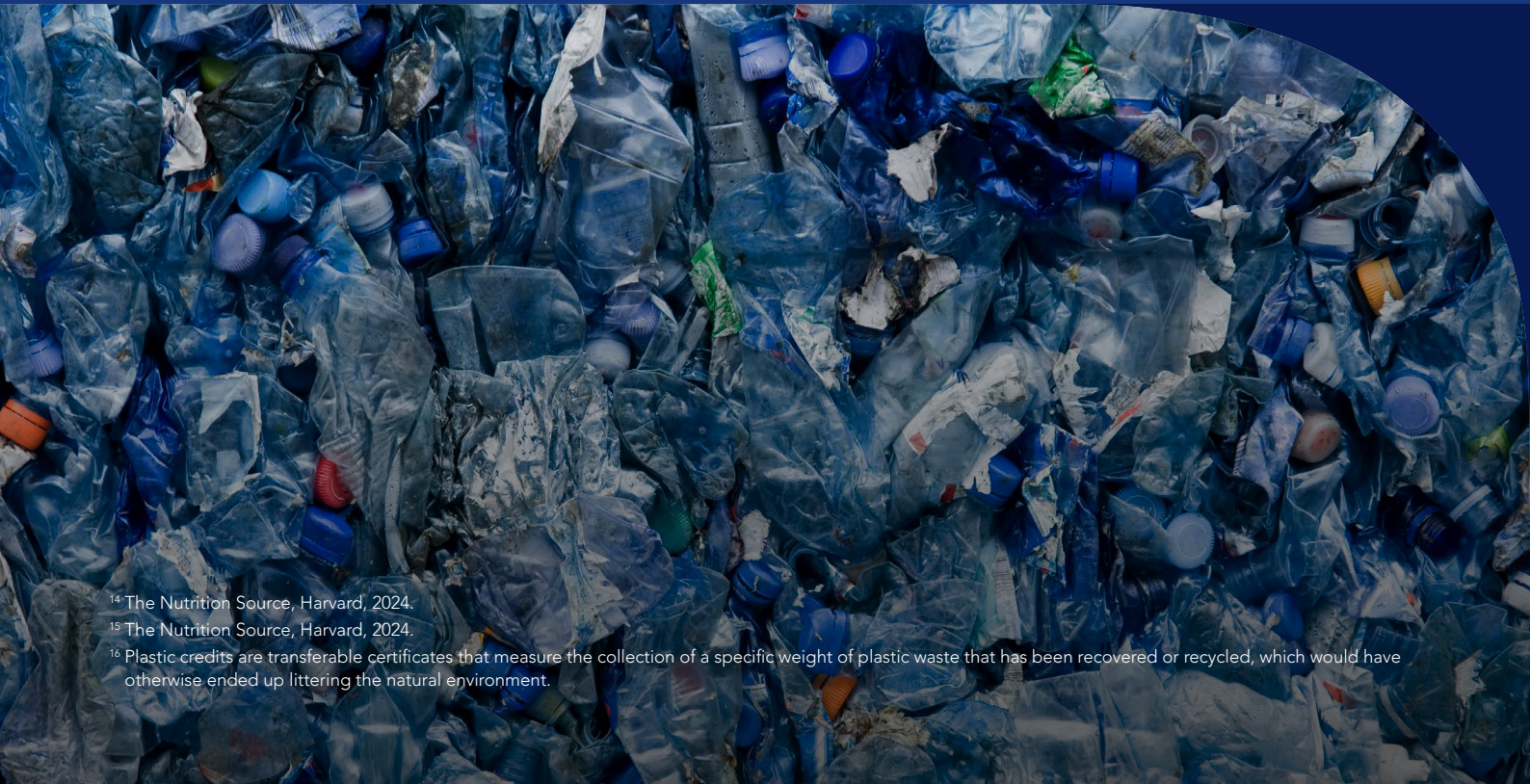


Source: Company annual reports.

Increasing recycling (and recycled content used in packaging)

The Indian government is to require that 30% of recycled plastic content is used in plastic packaging by 2025-26 (increasing to 60% by 2028-29). Varun has been proactive in this area. It has already committed to recycling 100% of its used PET bottles and has established a target to incorporate 30% recycled-PET into its packaging in India by 2025. The company has set up a joint-venture with Singapore-based chemical producer Indorama to manufacture recycled-PET at two locations in India, with these facilities set to be operational by 2025.

As it seeks to achieve its recycling target, Varun has been working with a third party, GEM Enviro Management, which specialises in the collection of packaging waste and recycling used-PET bottles into green products. The partnership enables Varun to gain plastic credits¹⁶ for the waste collected and recycled.

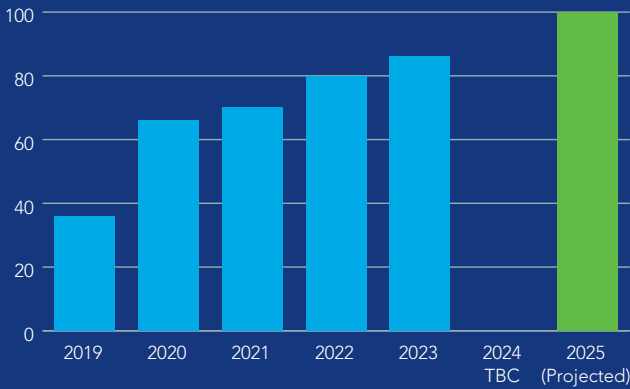


¹⁴ The Nutrition Source, Harvard, 2024.

¹⁵ The Nutrition Source, Harvard, 2024.

¹⁶ Plastic credits are transferable certificates that measure the collection of a specific weight of plastic waste that has been recovered or recycled, which would have otherwise ended up littering the natural environment.

Figure 3: Varun Beverages plastic waste recycled



Source: Company reports.

The GEM Enviro team works with ragpickers who collect packaging waste at large waste generation facilities. In light of our concerns about the welfare of such individuals, we are pleased that Varun has launched a programme that seeks to improve the livelihoods of ragpickers, providing for better working conditions and a fair price for the waste collected.

- We remain keen to engage further to understand what more Varun can do to support the welfare and wellbeing of ragpickers, while also accelerating the adoption of recycled plastics within its packaging.

A focus on water stewardship

The company has made meaningful improvements in recent years in terms of its water intensity – the proportion of water consumed during production of its products.

Varun has set targets:

- Sustain its water recharge ratio – the total water recharged per litre of water consumed – at above 2.
- Reduce its water usage ratio – litres of water consumed vs. litres of soft drinks produced – to x1.4 by 2025.

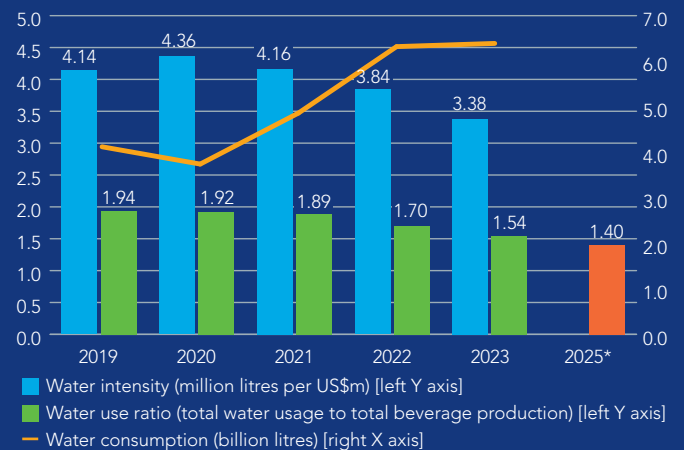
Varun’s water strategy seeks to achieve these targets by reducing water consumption per litre of production and cutting down wastage; improving water efficiency through process improvements; and harvesting rainwater to recycle and replenish groundwater levels.

In terms of recharging the local water table¹⁷, much of Varun’s positive impact is because of the

118 ponds it manages – approximately half of which are in water-stressed zones.



Figure 4: Varun water intensity
Target to reduce water use ratio to 1.4x in 2025 while retaining water recharge ratio >2



*Target.
Source: Company reports.

The company has conducted impact assessments on its water ponds and analysed the impact of the water rejuvenation projects on local communities. It found significant increases in crop yields, better land productivity and soil fertility and ultimately an increase in income and savings of local rural households (FY 2023).

- It is encouraging that the company has been reducing its dependency on production from water-stressed sites year-on-year. We are nonetheless mindful that the equity of access to water¹⁸ in these particular communities is an issue that needs ongoing monitoring.

¹⁷ Groundwater recharge or deep drainage or deep percolation is a hydrologic process, where water moves downward from surface water to groundwater. Recharge is the primary method through which water enters an aquifer.

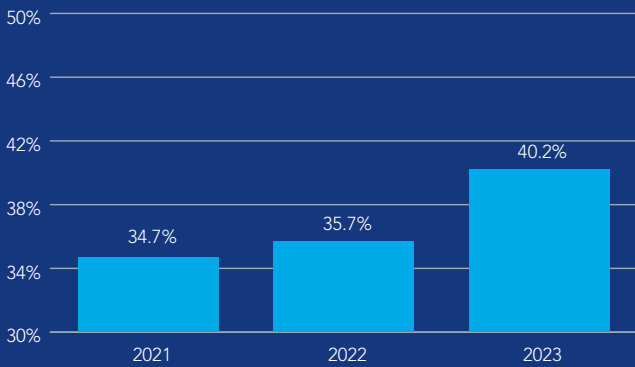
¹⁸ Water equity is defined as the proportional and equitable distribution of water related to environmental benefits and risks among diverse economic and cultural communities.

Alive to the obesity challenge

Varun has been working towards introducing healthier and zero-sugar variants of its products – in line with PepsiCo’s global strategy to reduce its overall sugar content.

The proportion of ‘low and no-sugar’ beverages in Varun’s product mix has gradually risen from 35% in 2021 to 40% in 2023. It includes some of Varun’s fastest-growing products such as Sting (energy drinks), Gatorade (sports drinks), Tropicana (juices) and bottled water as well as zero sugar variants of its carbonated brands (7Up Zero, Gatorade Zero and Pepsi Black).

Figure 5: Varun Beverages ‘low and no sugar products’



Source: Company reports.

As previously outlined, the relative health benefits of artificial sweeteners is a live debate, and one we will be tracking carefully in terms of the health benefits of these products.

PepsiCo is looking into developing its partnership with Varun to include the distribution of a wider range of healthy and fortified products across India; utilising the logistics and distribution infrastructure Varun offers could provide further opportunities for social impact creation – it’s an angle we will explore further with the company.

- While ‘low and no sugar’ products have potential health benefits for consumers (relative to sugar-sweetened drinks) we remain keen to discuss with Varun how it plans to innovate its ‘no sugar’ portfolio and enhance the accessibility of its more evidentially healthy products. The company needs to set out clear targets on how it intends to reach low-income populations, while guarding against the promotion of harmful products to children.

The proportion of ‘low and no-sugar’ beverages in Varun’s product mix has gradually risen from

35% in 2021 to **40%** in 2023.



Ten Largest Holdings as at 30 September 2024

Security	Country	% of Portfolio
Techtronic Industries Co.	Hong Kong	3.1
Yaoko Co. Ltd.	Japan	3.1
Reinsurance Group of America, Incorporated	United States	2.9
Trelleborg AB Class B	Sweden	2.8
PTC Inc.	United States	2.8
AptarGroup, Inc.	United States	2.7
STERIS PLC	United States	2.6
Wintrust Financial Corporation	United States	2.6
RPM International Inc.	United States	2.5
Equifax Inc.	United States	2.5
Total % of Portfolio:		27.6

The term "engage" discussed above includes direct engagement by the investment team as well as Federated Hermes stewardship division, EOS at Federated Hermes Limited. Engagement interactions are tailored to specific companies and seek to assess the most material ESG risks and opportunities, through long-term, continuous dialogue at the board and senior executive level. We may have multiple engagements with a company at any one time. Objectives are regularly reviewed until they are completed and are tracked using milestones. Objectives may be discontinued if the objective is no longer relevant, or because the engagement is no longer feasible or material.

Risk Considerations:

The Federated Hermes SDG Engagement Equity Fund's strategy is to target companies that the adviser or sub-adviser believes will contribute positive societal impact aligned to the SDGs. The fund may underperform funds that do not have such a strategy. Mutual funds are subject to risks and fluctuate in value.

The value of equity securities in the fund's portfolio will fluctuate and, as a result, the fund's share price may decline. Equity securities may decline in value because of an increase in interest rates or changes in the stock market.

Because the fund may allocate relatively more assets to certain industry sectors than others, the fund's performance may be more susceptible to any developments which affect those sectors emphasized by the Fund.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards. Prices of emerging-market and frontier-market securities can be significantly more volatile than the prices of securities in developed countries, and currency risk and political risks are accentuated in emerging markets.

Small-cap companies may have less liquid stock, a more volatile share price, unproven track records, a limited product or service base and limited access to capital. The above factors could make small-cap companies more likely to fail than larger companies and increase the volatility of a fund's portfolio, performance and share price. Suitable securities of small-cap companies also can have limited availability and cause capacity constraints on investment strategies for funds that invest in them.

Mid-capitalization companies often have narrower markets and limited managerial and financial resources compared to larger and more established companies.

Diversification does not assure a profit nor protect against loss.

Investors should carefully consider the Federated Hermes SDG Engagement Equity Fund's investment objectives, risks, charges and expenses before investing. To obtain a summary prospectus or prospectus containing this and other information, contact us or visit [FederatedHermes.com/us](https://www.federatedhermes.com/us). Please carefully read the summary prospectus or prospectus before investing.

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