S&P Global Ratings

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Inside Credit:

Who Will Pay For A Plastic-Free Future?

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Key Takeaways

- Branded consumer goods companies show varying degrees of preparedness for potential radical action on plastic waste. The largest consumer brands will most likely lead the way to set themselves apart from the competition and comply with tougher and not always similar rules around the world. We think this issue will test their strategic and financial policies, though have no immediate ratings impact.
- Rising consumer scrutiny and new environmental laws and regulations are driving demand for more environmentally friendly packaging solutions. The plastic packaging companies that we rate are responding by repositioning their polymer mixes, product ranges, and manufacturing processes to offer more sustainable packaging that contains a higher proportion of recycled materials and is easier to recycle.
- To adapt their product ranges in the next few years, we expect plastic packaging producers to incur slightly higher costs, which won't have a material impact on issuer credit ratings. However, over the next five to 10 years we expect a drop in demand for plastic packaging and increased design, manufacturing, and materials costs to weigh on ratings. In particular, leveraged plastic players that don't embrace more ecofriendly materials could see higher refinancing risks.
- Other packaging producers (paper, metal, and glass) might find viable opportunities to benefit from plastic substitution if they invest in product design.

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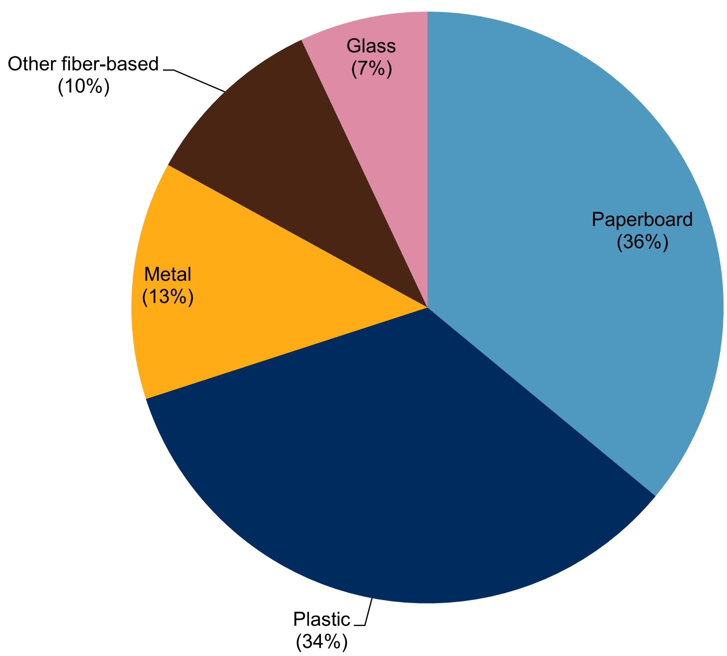
The anti-plastic movement is currently at the top of the global environmental agenda, buoyed by mass media visualization of damage inflicted by plastic pollution. As public concerns escalate, plastic packaging appears less attractive to consumers and is coming under increased scrutiny from regulators and legislators. S&P Global Ratings is observing how the plastic packaging companies we rate are responding by working with their customers, who are mostly consumer goods manufacturers and retailers, to offer more sustainable packaging solutions. We believe it unlikely that the costs of developing and manufacturing more ecologically friendly options can be fully passed onto consumers, who remain predominantly price conscious. Large global consumer brand owners will likely be the first to shoulder the burden, and potentially the ones to bear much of it. Smaller consumer brand owners with leveraged capital structures will likely be counting on high-volume demand for eco-friendly design from the large players to make sustainable packaging more economical.

Consumer dependence on plastic food and beverage containers will be hard to break

Although we expect a material reduction in the use of plastic packaging in the years to come, it will certainly remain indispensable in certain areas due to its unique properties. Plastic and paperboard packaging each account for just a little more than one-third of the global packaging market, metal packaging for 13%, other fiber-based packaging for 10%, and glass packaging for 7% (see chart 1). Plastic has the benefits of being lightweight, hygienic, durable, flexible, shatterproof, versatile, moisture resistant, and cheap. Its protective barrier properties (protecting food from pressure, humidity, light, and bacteria) make it difficult to replace in consumer applications. Plastic is strong and clear, allowing users to see what they buy. It also helps to prolong the shelf life of food and beverages. Soft drinks and waters, food that cannot be sold in wrappers and boxes (such as yogurt and spreads), as well as liquids and gels for personal and domestic use, are likely to call for modification of plastic packaging rather than outright replacement. Single-use plastic packaging for pharmaceuticals and medical devices is unlikely to come under scrutiny due to overriding concerns about infection control and effective performance.

Chart 1

Global Packaging Market By Material



Source: Smithers Pira.

Laws and regulations around the world have so far mostly targeted post-consumer waste recovery, making manufacturers contribute to the costs of collection and sorting. EU governments have implemented landfill restrictions as well as plastic levies. (Danone reported paying €61 million in packaging levies in 2018 alone.) Plastic levies in some countries are linked to the rates and quality of recycling and can go down if certain conditions are met. Outright bans have been reserved only for plastic items, which would not seriously affect the cost and delivery of major consumer staples. For example, the U.K. government recently announced a ban on plastic straws, cotton buds, and drink stirrers (effective April 2020), following the law to charge five pence per single-use plastic carrier bag, which reduced usage by 90% since its introduction in 2015. The French government has implemented similar measures. Rated plastic packaging companies have very limited exposure to such products, but this demonstrates how quickly demand for certain plastic products can change. Public attitudes to plastic waste reduction remain positive in principle, but are divided about the issue of responsibility. An international consumer survey of 4,000 respondents in four countries commissioned by global chemicals company Kemira showed that 58% of respondents in the U.S., 83% in Germany, 67% in Finland, and 93% in China were trying to reduce the amount of plastic in their lives. However, when asked whether they were willing to pay more for renewable packaging for food, 46%, 55%, 44%, and 85% responded positively, with the rest expecting brands to foot the bill.

We consider it unlikely that the EU or U.S. will take radical policy steps in the next several years, by either rewarding eco-design with lower environmental charges or introducing wider-reaching plastic bans. The European Commission is currently considering laws to ban or manage down the use of single-use plastic products and targets that all plastic packaging on the EU market will be recyclable by 2030. This is in line with commitments already made by the largest producers of consumer staples. Unilever has pledged to make all plastic in its products fully reusable, recyclable, or compostable by 2025, with 25% coming from recycled plastic content. L'Oreal Group, the global leader in personal care and cosmetics, has said that 100% of its plastic packaging will be refillable, reusable, recyclable, or compostable by 2025. Danone and Nestle Waters are developing a 100% plant-based and recyclable plastic bottle in partnership with U.S.-based Origin Materials. Danone's Evian brand is to switch to 100% recycled PET (polyethylene terephthalate, the most common thermoplastic polymer resin of the polyester family) by 2025. Policy differences across the world are likely to widen, however, making multinationals the most likely pioneers of environmental compliance. In particular, China might adopt stronger environmental measures, as shown by restrictions on importing materials for recycling under the National Sword policy (enacted in January 2018). Coca-Cola European Partners will move its Glaceau Smartwater to 100% rPET (recycled material PET) bottles in the U.K. by the end of 2020. The company has said that it will reach 50% rPET content across its entire U.K. portfolio in 2020, but further progress depends on the development of the nationwide deposit return scheme to enable more collection and reprocessing.

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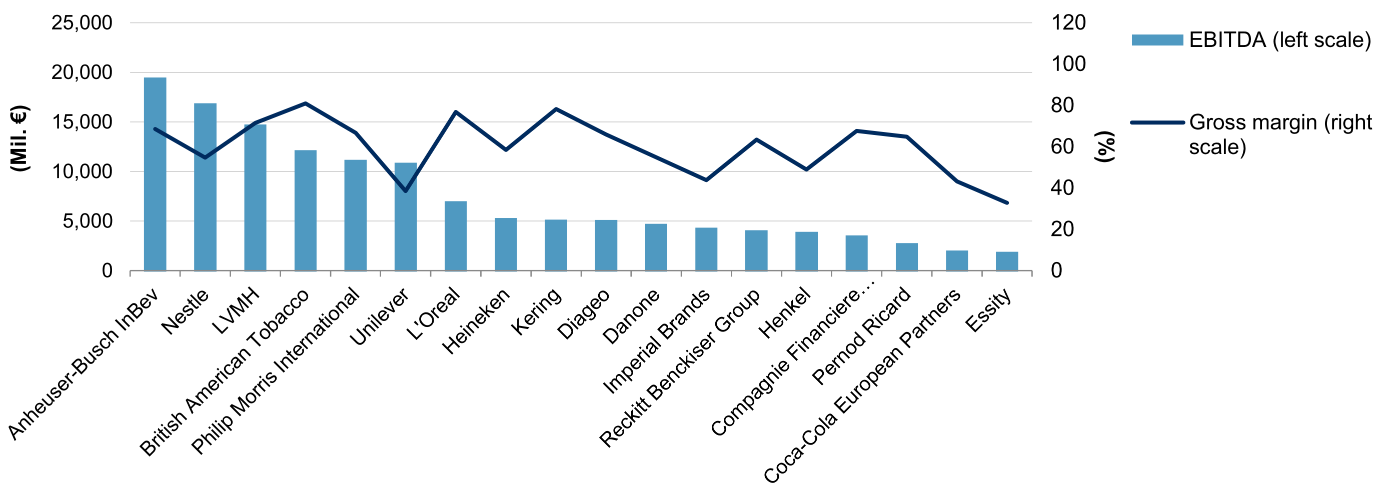
Large consumer brand owners will shoulder most of the burden in return for new product development

Ultimately, the cost of reducing plastic waste will likely reach the consumer via a broad range of newly launched products--and not through a uniform markup on each item. Additionally, consumers might have to put up with less convenience and variety in some products. We believe that plastic packaging companies and consumer brand owners will bear most of the costs of lowering plastic waste, with the brand owners taking a higher share of the burden. Yet, the cost of packaging plays a relatively modest role in the overall economics of branded food, beverage, and personal care companies (see charts 2 and 3). Gross margins of the largest companies are well in access of 50%, with the exception of Unilever and Essity, owing to a very high share of entry-level pricing products in their mix, mostly sold in emerging markets. Even the smaller companies have gross margins in excess of 30%.

Chart 2

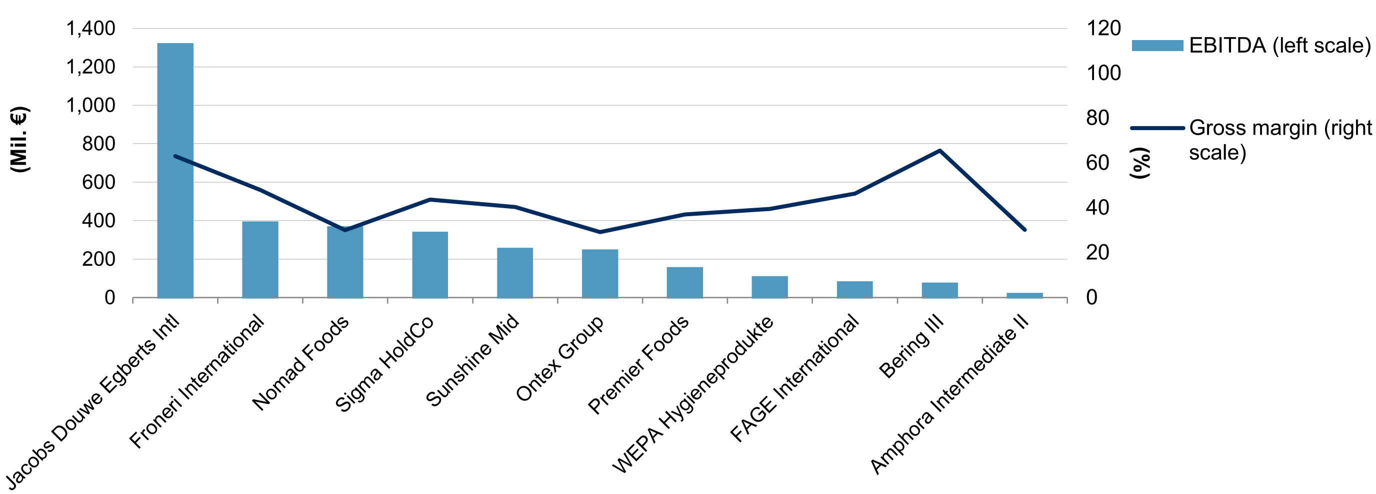
EMEA Largest Branded Nondurable Consumer Product Companies



Source: S&P Global Ratings.

Chart 3

EMEA Speculative-Grade Branded Nondurable Consumer Product Companies



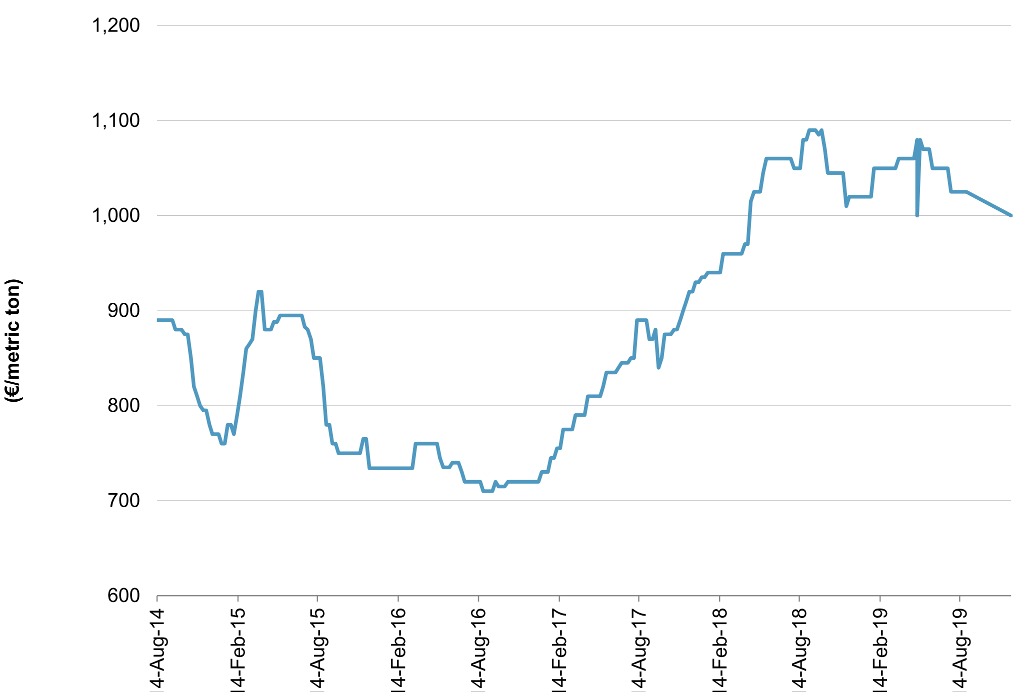
Source: S&P Global Ratings.

Profitability and growth for producers of branded consumer goods is driven by optimizing product volumes and mix, because like-for-like price increases are no longer feasible in most markets. New product development is therefore critical for brand equity and growth. The consumer goods industry is mature and highly competitive, even in emerging markets, and consumer brand owners have always tuned into consumer sentiment and changing tastes to remain relevant. Environmentally friendly reputation can deliver long-term benefits to increase and consolidate brand equity, especially with younger and more affluent demographics. Adidas saw a strong consumer response to its Adidas Parley range of high-performance sportswear. The range is made of polyester yarn created from marine plastic waste that is intercepted from beaches and coastal communities. Brand owners are also keen to avoid product boycotts--a consideration that was likely behind the recent decision by Coca-Cola and PepsiCo to end membership in the U.S. Plastics Industry Association that has lobbied for states to prohibit plastic bans across the country.

Regardless of lobbying groups, there is a growing trend among plastic packaging companies to use a higher portion of recycled plastics as an input in their production process. This has led to an increase in demand and therefore prices for rPET, the most widely recycled plastic (see chart 2).

Chart 4

Prices For Recycled PET In Northwest Europe



Source: S&P Global Platts.

The past decade has seen tangible progress in weight reduction for packaging, not least as a response to peak oil prices that clashed against weak consumer confidence in developed markets in 2008-2010. For example, Unilever has reduced the weight of its packaging by 18% since 2010 thanks to design changes and lighter materials. Personal care companies are increasing refill options. For example, L'Oreal's division L'Oreal Professional allows consumers to refill their shampoo bottles at the hairdresser's, saving the equivalent of 40% of the weight of a bottle. Plastic producers continue to focus on lighter-weight products as they require less energy to transport and thereby reduce greenhouse gas emissions. Flexible (as opposed to traditional rigid) packaging is lighter, accommodates irregular packaging sizes, and is easy to brand.

Increasing product recyclability is a tougher problem to solve than either reducing weight or improving collection. Not all plastics can be recycled and local councils and national governments often lack the infrastructure required to enable effective recycling. Consumers have been recycling some packaging for years, but they are now demanding the ability to recycle more and to really understand how recycling works. In order to increase the recyclability of their products, plastic packaging producers are reducing the number of chemicals, laminates, and colors of their polymers. Mixing (or multilayer) materials can also make it more difficult to separate packaging for recycling. In some cases companies are moving toward bioplastics, which being plant-based are fully biodegradable under the right conditions. For example, the Dubai-based producer of biaxially oriented polypropylene films Taghleef Industries Holdco has a biodegradable film made out of renewable sources (polylactic acid, a bio-based resin).

Plastic packaging companies are trying to ensure that consumers recycle their products through an increasing range of options. Currently Europe recycles an estimated 30% of plastic packaging (mostly PET) versus only 9% in the U.S. Enhancing plastic recycling rates will reduce greenhouse gas emissions, avoid waste buildup, decrease dependency on finite petroleum reserves, and recover the economic value of plastic waste. In many cases plastic packaging producers seek to achieve this by collaborating with local communities and regulators. Some polymers are more environmentally damaging than others and may be more or less widely recyclable. For example, in the production of plastic films, PVC (polyvinyl chloride) is generally a less environmentally friendly option, but PET alternatives are more expensive and more layers are needed for the same barrier properties. Typically PET (used for products such as water and soft drink bottles, cleaning products and cooking oil) and HDPE (high-density polyethylene, used in applications such as detergents and bleach bottles, shampoo bottles, and rubbish bags) are most widely recyclable, as opposed to PVC and polystyrene, which are seldom recyclable. Large consumer companies are targeting PVC use as one of their sustainability metrics: L'Oreal Group has reported that it has not used any PVC-based material in the production of its finished products since the start of 2018. Tougher regulation and clearer environmental incentives are likely to be positive for plastic packaging manufacturers because they will gain higher volumes and more product focus, despite higher raw material and manufacturing costs.

Large consumer companies are targeting PVC use as one of their sustainability metrics.

Designs to incorporate recyclability back into the original product are a relatively new notion. Some rated plastic packaging manufacturers have chosen to "forward integrate" into plastic recycling. For example, Denmark-based plastic tray producer Faerch recently acquired 4PET Recycling, a Netherlands-located plastic recycling company. This allows Faerch to transform its used plastic PET trays into raw materials for their tray production. We note that vertical integration into the recycling of a single polymer is less viable for plastic packaging producers exposed to a wide range of polymers.

Paper, metal, and glass packaging producers might find opportunities for growth if they invest in design

Paper, metal, and glass alternatives to plastic still have a role to play if they work in close cooperation with their retail and consumer goods customers. Polymer-based plastics are not biodegradable, and plastic packaging can be recycled only a couple of times (it also requires the addition of new plastic to improve integrity). Working with key customers to provide more effective and sustainable packaging solutions has been integral to the operations of many container and packaging companies for years. Yet, in the last year or two, and even more so in recent quarters, we have observed a step-up in the number of companies pledging to reduce the use of plastic packaging in a bigger way than ever before or even to stop using plastics altogether.

Retailers' environmental pledges in particular are playing an important role in reducing the use of plastic packaging for consumer products. For example, last year, the second-largest U.K. frozen food retailer Iceland Foods (Iceland Topco Ltd.) pledged to remove plastic packaging from its own label product range by 2023. Its objectives include moving production of frozen meals out of black plastic trays (which are notoriously difficult to recycle), switching certain fruit and vegetables out of plastic punnets into pulp-based trays and exploring plastic-free alternatives for milk containers. J Sainsbury PLC (not rated) recently committed to halving its total plastic use by 2025, by introducing several initiatives to reduce (use), replace (with recyclable alternatives), and recycle. The company has already removed black plastic trays from chilled ready meals and removed plastic from a number of fruit and vegetable lines. The e-commerce market is also decreasing its use of plastic packaging. Amazon has outlined its strategy for a more sustainable future, including hugely reducing the number of packaging components, packaging volume, and the amount of packages shipped by air.

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We believe that paper companies will likely benefit the most from plastic substitution. Paper and cardboard are quickly biodegradable and recyclable (up to seven times). Paper-based corrugated box producer Smurfit Kappa Group PLC (SKG) notes that its hexacomb protective packaging product, which replaces polystyrene with a paper-based solution, has proved particularly popular in the U.S. and Mexico. South Africa-based forest products group Sappi Ltd. views barrier technology papers as a growth opportunity; heat-sealable Sappi Seal paper is completely recyclable and can replace existing plastic coated packaging. Producers of starch, such as Suedzucker, are already part of the supply chain for the cardboard packaging needs of online retailers.

The appeal of metal as a fully recyclable material is balanced by its low biodegradability and impact on taste in beverages. Companies like Trivium Packaging have benefitted from the move away from plastics. They now offer wine in aluminum cans as customers are switching away from single-use PET bottles. U.S.-based metal beverage container company Ball Corp. noted in its recent results that positive volume momentum is continuing as certain customers (particularly in Northern Europe) switch from plastic to aluminum packaging. The company states that its metal cans are 100% recyclable and that store-to-shelf recycling (as a new can) can occur in just 60 days. When transported, aluminum has a lower carbon footprint than glass, due to its lighter weight. However, we understand that aluminum has higher recycling costs than plastics.

Glass packaging has the lowest substitution potential, in our view. Although glass is fully recyclable, transportation is environmentally expensive, and carries the risk of breakage that results in more waste. Glass is also not considered biodegradable. Emerging markets account for a high and growing share of glass usage, because of glass bottle return schemes that provide significant economic benefits to consumers and manufacturers.

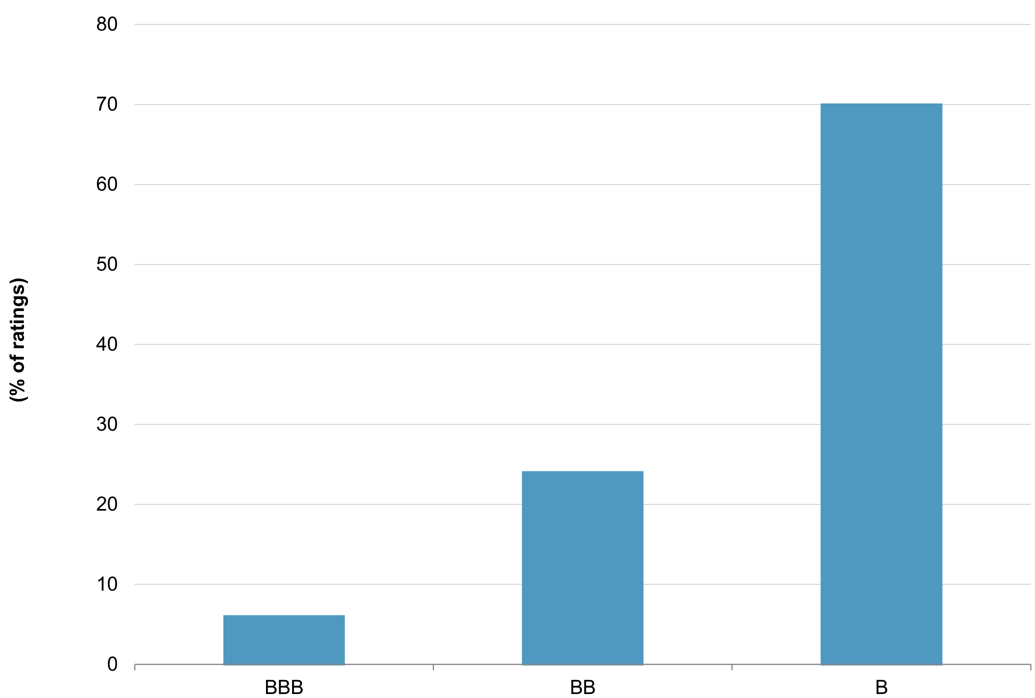
Leveraged players that don't diversify away from plastics could see higher refinancing risks

Over the next couple of years, we expect plastic packaging producers to incur slightly higher costs to adapt their product ranges and make them more sustainable, which as we have stated is unlikely to have a material impact on issuer credit ratings. However, we believe rating pressure are more likely to stem from other factors such as price increases for raw materials and aggressive financial policies of private equity-owned companies. That said, over the next five to 10 years, we expect a significant decrease in demand for plastic packaging. Potential new laws and regulations could push down volumes, which is likely to weigh on ratings as consumers switch away from plastics. What's more, a spike in recycled plastic prices could reduce cash flow and weaken credit quality, particularly at the lower end of the scale. For that reason, a failure to diversify into a broader range of eco-friendly materials by especially leveraged plastics players could lead to accentuated refinancing risks over the medium to longer term.

Two-thirds of the packaging companies we rate based in Europe, the Middle East, and Africa (EMEA) are in the single 'B' rating category, including all of our primarily plastic producers of packaging (see chart 5). This is largely because many of our rated companies are private equity owned, therefore have highly leveraged financial risk profiles and aggressive financial policies. Plastic packaging producers typically have lower margins than the more capital-intensive paper and glass packaging producers.

Chart 5

Issuer Credit Rating Distribution For Packaging Producers In EMEA

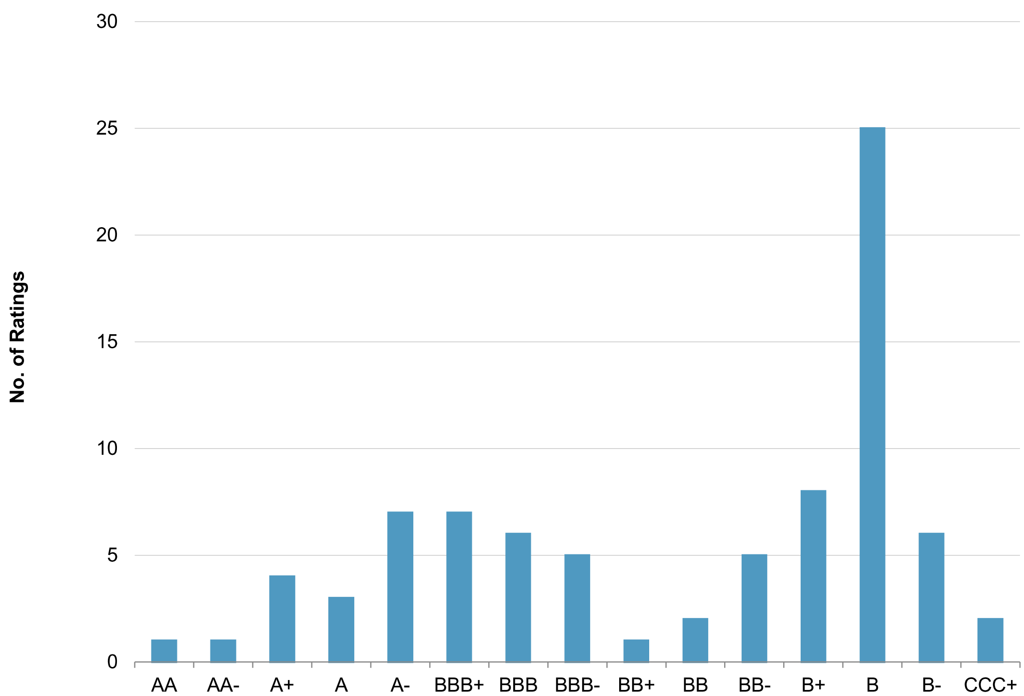


Source: S&P Global Ratings.

The consumer goods sector in our view will show a divided response to the cost of plastic waste reduction. The rated EMEA consumer products euniverse, for example, is polarized between large and diversified multinationals and narrowly focused leveraged businesses (see chart 6). The first group is leading the development of environmentally friendly solutions to reduce the use of virgin and nonrecyclable plastic in the highest-volume categories, such as food, beverages, and personal care. It will probably bear most of the transition costs, motivated by remaining relevant to consumers and maintaining market shares globally. A short-term escalation in the scale of such investments is unlikely to materially move the credit quality of highly rated consumer goods companies, so long as they maintain strategic leadership in their product categories. Smaller companies have so far chosen to remain in the wings, waiting for the big players to ramp up demand for sustainable packaging, making it mainstream and affordable. This strategy will likely work in the long run, but leaves the companies vulnerable to any unexpected radical shifts in environmental regulation as well as consumer boycotts. The retail sector is unlikely to offer support to private-label manufacturers and smaller brand producers. That's because retailers are currently preoccupied with reducing their real estate holdings, investing in omnichannel strategies, and coping with potential disruption to crossborder supply chains. Consequently, we view efforts to switch to more sustainable packaging as an important contributor to the reduction of refinancing risk for more narrowly focused consumer goods companies.

Chart 6

Issuer Credit Rating Distribution For Consumer Products Companies In EMEA



Source: S&P Global Ratings.

Related Research

- S&P Global Ratings Publishes EMEA Mid-Year Corporate Credit Outlook And Industry Top Trends Report, July 25, 2019
- ESG Industry Report Card: Forest and Paper Products, June 3, 2019
- ESG Industry Report Card: Consumer Products And Agribusiness, May 21, 2019

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