TRANSCRIPT

Baby Formula Crisis and Australia Goes Green

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Mike Disabato: What's up everyone, and welcome to the weekly edition of ESG Now where we cover how the environment, our society, and corporate governance affects and are affected by our economy. I'm your host, Mike Disabato, and this week, we have two stories for you. The first is on the baby formula crisis in the US sparked by the closure of an Abbott Laboratories plant in Michigan, and then we discuss Australia's election results that were heavily influenced by climate change concerns. Thanks as always for joining us. Stay tuned.

There is a nationwide shortage of baby formula in the US due to a shutdown of an Abbott laboratories plant in Michigan in February that produced nearly 50% of the nation's infant formula. Dr. Robert Califf, who's the Head of the USFDA, told the US House of Representatives panel on Wednesday this week that an FDA expansion of the plant found "egregiously unsanitary conditions." He detailed leaks, standing water, and faulty key production equipment that allowed bacteria to root into its infrastructure at the plant, persist, and then allegedly infect Abbott's baby formula.

He said, "We have no confidence in the integrity of the quality program at the facility." So Abbott seems to be in a lot of trouble, but I should note, Abbott is not alone in its quality control issues. The healthcare equipments and supplies industry is replete with instances of recalls and problems with safety and quality, and with all of them, when things go wrong, they go really wrong because of the vulnerability of their customers. But this tragic problem at Abbott highlighted two important ESG aspects at these companies that are important to pay attention to.

There's the quality program, or lack thereof, that was an operation at the facility. We call quality programs the company's product safety and quality procedures by the way. And then, there's the governance structure or concern that Abbott's board, though on paper well-structured, seemed unable to prevent a number of problems at Abbott's facilities, this being the most public and most damaging. So before I get to my guest and colleague, Namita Nair, who covers Abbott for us, I wanted to give you the news bulletins on the story, and then we could kind of drill into the ESG relevant details.

So Abbott voluntarily issued a recall for its infant baby formula after four babies got ill, two of which died. And this happened after they consumed Abbott's products. Abbott responded saying that while they had found the bacteria present in their facilities, they had not found the bacteria present in their products that the babies consumed. The FDA disagreed with that, and the FDA also uncovered potential manufacturing problems. They did a review of internal documents and saw that the company had destroyed products because of the same bacterial contamination in the past. But this is all kind of still under investigation.

There's one more complicating factor to this. A whistle blower that used to work at the plant said he complained to both the FDA and Abbott in December 2021 about unsanitary conditions at the Michigan plant in question, but nothing had happened. By the way, Abbott does have whistle blower protection. It's not like they silenced this individual. It's just that they nor the FDA seemed to actually pay any heed to it. But I think the first thing we want to look at for this story is the quality control that was at Abbott. Again, we call that product safety and quality, which Namita is going to say soon. I asked her first how Abbott was on that factor overall and just to give us kind of a layout about Abbott and its product safety controls.

Namita Nair: For a company in the healthcare equipment industry, Abbott has really high practices, okay? It has really strong practices. From our model, what we find is that the company's practices are 8.3 out of 10, which is really good. But the place where all this goes for a toss is in the performance score. So the company is 4.8 out of 10 on performance, which is low for this industry. And of course, all the big companies in this industry do have a lower performance score.

Mike Disabato: Quick break in here. Namita says that all companies have a lower performance score, and I will explain the difference between the performance and practice score in a moment. But what she means is that large healthcare equipment companies all have issues like recalls. It's an unfortunate reality, but a true one. Scale means more problems. Okay, here's Namita finishing up.

Namita Nair: But the standout thing about Abbott is also that it has a large number of controversies related to product safety and quality. So, that's what differentiates this company from others. And the fact that it's very tightly regulated because it's already in very highly risky businesses, right? That exposure to risk is much higher for Abbott anyway.

Mike Disabato: Yeah, the US government is worried about the production of infant formula. They need to highly regulate that and make sure that there's nothing wrong because even two children dying, four children getting sick is a massive national problem. But what Namita mentioned there, the practice score and the performance score, you could think about the practice score as the systems the company has in place to ensure nothing goes wrong score. But the performance score is the on-the-ground score, what actually happens in practice from that theory basically.

And two factors to look at that are useful to see how a company's performance score is are its controversies that it's involved in and its product recalls. Right now, Abbott is involved in six ongoing controversies related to product safety and quality, aside from the baby formula one we are discussing right now. That's a relatively large number by the way. The most serious and severe controversy that they're dealing with is an issue with a heart valve repair device that Abbott made, which has caused 392 patient fatalities, 97 of which Abbott failed to report.

For recalls, Abbott has had to recall around 340 of its products since 2011. 30 of those were because the products could cause serious health problems or death. That is a lot, but remember, the bigger the company, the more there are recalls. If you look at the recall data we collect for the healthcare equipment and supplies industry as a whole, you see that a lot of large players in the industry have had a lot of product recalls. It's just kind of the way the game goes. But the reason Abbott is in the news, the reason it will have regulators breathing down its neck for a while after this, is because of the nature of its product. And that's why its risk exposure is so high. Recalls are one thing. Recalls that have impacted children are a totally different thing.

Namita Nair: The fallout of these recalls, it's because of the nature of the product, right? This is infant formula. It's very crucial. And what we need to understand is that the FDA operates a very tight regime for infant formula, and the nutritional requirements, the labeling requirements are really stringent for the USFDA. These are also very high barriers to entry for other companies, right? So, you have an essentially tightly regulated market and very few players. And there are also some barriers to importing formula in the United States. So, the tariffs on these imported formulas can be as high as 17.5%.

Mike Disabato: A 17.5% tariff is a big increase in your product's price and it basically stops any international competition for Abbott and the other three companies that make baby formula, that is, Perot, Nestle, and Mead Johnson. Baby formula is already very expensive. The US Department of Health and Human Services says, "Parents should expect to spend 1200 to $2,000 US if they need to use formula exclusively for their baby's first years."

So, let's look at the conservative end there. Let's look at 1200 inflated by 17.5%. That's over $1,400. And if you're already struggling to feed yourself and your baby, that price increase is too much to bear. The tariff is one of the reasons why nearly 100% of the baby formula for the US is domestically made. So, Abbott's mess up is a serious problem now. And it means for the long term, the company is going to have to adhere to more regulatory scrutiny. And this is often what we see as one of the major risks for poor performing companies operating in an industry that is vital to a country for it to operate. If you cannot keep your practices up with your policies, then regulation will come to you.

Namita Nair: Abbott has entered into an agreement which is called a consent decree with the FDA. And under that, it'll be supervised by the FDA, there'll be an independent expert who has to drop improvement plans for restarting the production, and it'll also have to undertake FDA specified measures to increase the product safety and quality. And that's all in compliance with the FDA Good Manufacturing Practice standards.

Mike Disabato: Okay. So, here's what Namita really means when she uses all that jargon about the FDA and the regulations that Abbott's going to have to deal with now.

Namita Nair: So you'll have to put in more money, you'll have to put in more stricter quality controls. There will be an expert. So, an independent audit also of your plant to see whether you are complying with these regulations. So basically, this looks like ongoing regulatory scrutiny for the company and also increased costs for compliance.

Mike Disabato: And before you start worrying about whether or not Abbott should be able to pay that, they should have no problem putting up more money into their systems. Now, why do I say that? That sounds a bit subjective. Well, here's where we shift from the products to the governance, because the board of Abbott has a lot of say where the company strategically uses its capital. And Abbott has lately been putting a lot of money into places that are not its facilities. For example, Abbott's CEO, Robert Ford, has gotten quite the pay package as of late.

Namita Nair: This company has the highest CEO total awarded pay in its peer group, which is already something that... It stands out, right? Among all the companies in this industry, this is the one that has the highest.

Mike Disabato: That highest salary translates into about $24 million awarded in 2021. That is around 300 times more than the average employee at Abbott. And so, let's compare that to the CEO that everyone likes to hate on recently, Meta's Mark Zuckerberg. Mark Zuckerberg's CEO to pay ratio is only 96. Now, Abbott has also made a lot of stock buybacks at a really unfortunate time for the company. If the whistleblower is to be believed... Remember I said a whistleblower allegedly talked to both the company and the FDA in December 2021? Well, Abbott knew about these quality control issues in 2021, but it was during that time, that it was engaging in a $5 billion stock buyback program and increasing its dividends to shareholders.

Now, none of these things are inherently bad. You can pay your CEO a lot of money, you can do stock buybacks, you can increase your dividends to shareholders. But these actions raise eyebrows for stakeholders outside of the shareholder community when a company has been told by the FDA that their systems are "egregiously unsanitary." And stakeholders outside of shareholders are important for Abbott's board because the US government actually buys a lot of Abbott's products. Abbott is part of what's called the Special Supplemental Nutritional Program for Women, Infants, and Children, or WIC, and that's in the US, and through grants, it helps states buy important things like baby formula. And Namita told me that Abbott supplies this program with around 47% of its products. So with all this, I asked Namita what she thought the effects that this controversy would be on the company's board, if there would be any backlash or larger shifts in its governance.

Namita Nair: As part of the consent decree, the company has already restarted operations at that plant. Any fallout of that is only... It might manifest in the days to come. But I would say that the company's going to pay its dues in terms of increased regulatory scrutiny and possibly having to incur a lot of compliance costs to meet the regulatory standards. That's the most that we can expect, because this is a single facility issue. And also, if we were ever thinking of in terms of people switching from one formula to the other, that's not going to happen because they've cornered a very large chunk of the market.

Mike Disabato: Right. There's a benefit in being the biggest of an already small number of producers that make a product. You're more insulated when something bad happens. Still, there's been one signal that shareholders are actually unhappy with how the board is dealing with the company's longterm risks.

Namita Nair: There is a significant number of votes against the head of the company's risk committee. She has about 23.2% of votes against her, and she's the Chair of the risk committee. So that makes it a cause of concern, especially in these turbulent times for such a company.

Mike Disabato: Okay. So, that's a signal that people might be a little bit worried about how Abbott's been handling its on the ground operations. And that's the big difference there what we talked about earlier, between its actual performance and its practices. And I think for Abbott, whether its leadership can weather this turbulence will likely be if it can ensure that on the ground performance can better match what it says it's doing on paper. They say and do all the right things Abbott does, but one reason that we look at what's going on the ground and what systems the company has in place is the two can often be in conflict. And when that happens, you can find yourself the subject of a hearing at the US House of Representatives.

Australia had some very interesting election results as it pertains to climate change. It held its election on May 21st, that's a Saturday, take note, America, and its greens and eco-conscious independence made the largest gains which, let me tell you, is surprising. Not because I am Australian, unless I have a stake in the country's election, but because Australia's current emissions profile hasn't been great. If you look at our sovereign warming potential metric, which looks at the carbon emission trajectory of a country based on its current emissions, Australia is right there at the top. And their previous prime minister, Scott Morrison, was heavily criticized for ignoring the emissions of his country. But it didn't seem that voters mattered at the time.

But now, incoming Labor Party Prime Minister, Anthony Albanese, who ousted the current prime minister has vowed to be better on climate, and he was voted in on that vow, or so pundits say. And he will likely get together with the Greens to form a coalition government. So this potential abrupt change for Australia, if it comes to fruition, will certainly impact the business and investor community there. So to talk about that, I have on the line with me my two colleagues who cover one industry that will certainly be impacted, the energy industry. They are Elchin Mammadov and Antonios Panagiotopoulos. So Elchin, I want to start with you because I want to talk about coal, one of Australia's largest export commodity, and as well as the power industry in general. How do you think they are likely going to change because of this election?

Elchin Mammadov: When it comes to power and coal, I'm cautiously optimistic. Again, I wouldn't hold my breath and expect some major reforms to happen in the very near term. And there are reasons for that. However, if you look at what the Anthony Albanese said, he said, "We can end the climate wars. We can be the renewable energy superpower." That sounds great.

And the other couple of things that work in favor of greater climate ambition, at least in the power sector, is economics of renewables are very strong compared to fossil fuels. It's cheaper to build renewables than fossil fuels. Just 6% of coal and 6% of gas flight capacity is planned to be deployed in Australia over the next decade or so. By comparison, there's around 45% of solar and 35, 37% of wind that is planned to be built out in Australia. And that's business as usual. This is what the companies are planning.

Mike Disabato: So, let me cut in there real quick and just summarize. So even before the election, the energy sector was going to domestically shift to renewables in their future planning. But the export market is still pretty heavily dominated by coal. I know they've said that by 2030, they want to move away from exporting fossil fuels, especially coal, and move to exporting hydrogen, especially green and blue hydrogen. But these are still in the planning stages. Maybe, these plans are going to become more possible because of the new government. So Elchin, are you really just all positive on this move, or is there some other things to look at?

Elchin Mammadov: On the negative side, the timing for the reforms is not great. As you know, some of the countries are entering recession in the world. The energy prices are going through the roof across the world, including Australia, where I think they rose 140% in first quarter versus a year ago. So reducing the price spikes for the industry and households will be the major focus for any government, be that Green or Labor or Liberal government.

So, I don't expect the new government to bring back the carbon tax that was adopted and then scrapped two years later in 2014. So because of affordability reasons, I don't expect any carbon tax to be reinvigorated. And again, maximizing export revenues could be an easy short term solution. That means selling more fossil fuels abroad in order to sustain Australian economy. But in the longer term, we do expect to see a stronger climate ambition, now that the Greens and the Labor, if they can get together and form a coalition.

Mike Disabato: Okay, Antonios, let's say this all goes well. Let's say the government lives up to its mandates and does a push for a lot of climate change regulations onto the market. Do you see any immediate on the ground impacts for any companies?

Antonios Panagi...: So there is an example of Chevron that has failed to meet the targets for their carbon capture and sequestration project, the Gorgon LNG. Now, the company is already facing potentially some fines. And in the past, the previous government has stepped in and has bought those allowances. However, if things for climate become stricter, then companies that are not meeting their targets, be that for CCS or even reduction targets, they may be facing fines.

Now, interestingly enough, from what we are hearing from companies, even in those sectors that are most likely going to be affected like coal, oil, and gas industry in general, all these assets have at least a 30-year lifespan. So, what investors and companies want is some sort of stability that they can plan ahead when it comes to carbon and when it comes to climate regulations. So overall, yes, we see a bit of a switch in direction. This remains to be confirmed, whether this is going to be the way forward for Australia. However, I will agree with Elchin that, at the moment, there are two important factors. One is climate change. The other one is the rising cost of energy. So any government that comes up, they will need to balance between the two.

Mike Disabato: Can you quickly tell me a little bit more about that Gorgon carbon capture and storage plant, that CCS plant? I know that's been in place for a while, right? And it's been the subject of a lot of talk.

Antonios Panagi...: The Gorgon thing is already in place and has been since 2016, 2017. Australia had a five year... Sorry, Chevron had a target that in five years, they would be able to capture 80% of the emissions emitted from their LNG facility. The rumors are that Chevron has not disclosed yet what it has managed to store. However, so far, the news are saying that it's about 30%, so 50% lower than their stated target, and they are expected to face some fines. Our expectation, or at least the way this has been, if you like, portrayed, is that these fines are likely to be higher now that the government's focus is mostly going to be on climate.

Elchin Mammadov: And by the way, what Antonios is saying about the CCS and how it hasn't gone through as planned is quite important, because current Australian target of net zero by 2050 relies heavily on CCS-

Antonios Panagi...: CCS.

Elchin Mammadov: And on carbon offsets. But yeah, so if CCS is not working as planned, then they should revise their target probably or look to deploy more renewables.

Mike Disabato: Yeah. And I think the troubling thing about that Gorgon carbon capture and storage plant failing to meet its goals is that not a lot of the major oil and gas companies that have tried to introduce carbon capture and storage have been successful. And if these companies aren't successful, then a lot of other people are not going to be successful with their carbon capture and storage because even though they're high polluters, they are also innovators and the people that are most knowledgeable on how to actually remove carbon from the atmosphere as well. So, it's a troubling dynamic.

And that's it for the week. I wanted to thank Namita, Elchin, and Antonios for talking to me about the news with an ESG twist. I wanted to thank you so much for listening. If you like what you heard, don't forget to rate and review us. It helps move us up on podcast lists and more people can find our podcast that way. And if you want to hear me each week, or Bentley each week, don't forget to subscribe and you'll get our podcast wherever you get your podcast at the moment. Thanks again, and talk to you next week.

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