Marketing Communication

Global Asset Management

Biscuits, barriers to entry and the investment bottom line

How the ingredients in your favourite snack can give large-cap corporates a balance sheet edge.

Do you know the definition of a cake? How about yoghurt? What qualifies as low-fat versus non-fat?

At first glance readers may stifle a yawn, but seemingly banal definitions can reach into the heart of a company's business model, ultimately hitting its bottom line. The financial implications can run into the millions and, for consumer staples stocks, can constitute barriers to entry for smaller players, giving incumbent corporates a potential advantage.

Our interest in this topic was piqued by a snippet in an NPR article detailing how the US government had decided that French dressing (a misnomer as it's an American invention,) no longer required certain regulations. One might naturally think competition regulation, or perhaps food safety. But actually, the regulation of said salad dressing went as far as the ingredients list: 35% vegetable oil was a must, tomato paste and spices were optional extras.

This regulation had held uncontested since the 1950s, but after an explosion in appetising alternatives, such as ranch and Italian, the US Food & Drug Association (FDA) agreed to revoke the 'standard of identity' for the product in 1998, on the basis it no longer promoted fair dealing in the interest of consumers.

Another dietary revocation was for the identity standards for yogurt, low-fat yogurt and non-fat yogurt. Under the latest rules, the latter two are covered by the FDA's general definition, which allows modified versions of traditional foods, such as those sweetened by agave rather than sugar. It also establishes the minimum amount of active cultures yogurt must contain to bear the 'live' label.

"The consequences of these seemingly trivial matters can have huge and long-lasting financial implications for corporations, and therefore their shareholders. "

For example, the FDA's announcement of the Nutrition Innovation Strategy in 2018 was a significant shift in direction, with a new focus on nutritional science while simultaneously trying to allow flexibility for innovation. It prompted major strategic shifts at a management level. While we may not see these shifts immediately reflected in a company's share price, the longer-term impact on profitability, and consequently a company's ability for capital expenditure and/or distribution to shareholders, all feed into its profile for prospective investors.

For example, the matter of whether a baked good is a cake or a biscuit might superficially appear to be a debate limited to a peculiar British obsession. But it warranted a longwinded legal dispute in the early 1990s. A court was required to settle whether McVitie's Jaffa Cakes were indeed cakes not biscuits. Why does it matter? The ruling would have margin implications to the sum of £200 million for McVitie's[1]. Biscuits were deemed a luxury item under UK law, so full VAT would be levied at 20%, whereas cakes were regarded as a staple food, with a zero-rate VAT applied. UK tax authorities argued that Jaffa Cakes were biscuits but the case was ruled in McVitie's favour as it highlighted how cakes harden when they go stale, while biscuits soften. The result is that £1.19 billion worth of Jaffa Cakes made every year are free of VAT.

Unfortunately for Procter & Gamble, the manufacturer of Pringles, it saw a similar ruling go in the government's favour after arguing passionately that the snack was not a crisp (potato chip) in an attempt not to attract VAT.

The ruling left Procter & Gamble facing a tax bill of millions and the court case also had the unfortunate result of the public discovering that Pringles are made from less than 50% potato[2].

The regulation of such matters isn't limited to the world of consumer goods. In the 1890s, the US Supreme Court altered the definition of the tomato when it ruled that importers were required to pay the port duties as if it were a vegetable (even though botanically it is a fruit). In the UK, tax authorities ruled in 2014 that bridge was a game and not a sport, so clubs could not reclaim VAT on contest fees[3].

While perhaps curious from a trivia perspective, the reasons for this level of regulatory scrutiny are well founded. They facilitate a well-functioning market economy, keep consumers safe, labelling honest and ingredients lists from becoming opaque. The reason this is important for investors, is that keeping up with regulation can be an expensive business. There are direct costs associated with product categorisation, as well as indirect ones in the form of safety and registration requirements, and implications for how a product is marketed. Therefore, it is vital for companies to be up to date on these matters and to be exceedingly sure-footed in how they navigate the landscape.

This regulatory complexity can create barriers to entry for new players, while the larger incumbent leaders typically benefit from having legal and product development structures in place to keep abreast of regulatory changes. When the implications of falling fowl of a definition can result in a £200 million tax bill, this is something that shouldn't be underestimated by investors.

1 Kersey's Solicitors, 2021
2 The Guardian, 2014
3 The Guardian, 2014

This document is provided by RBC Global Asset Management (RBC GAM) for informational purposes only and may not be reproduced, distributed or published without the written consent of RBC GAM or its affiliated entities listed herein. This document does not constitute an offer or a solicitation to buy or to sell anysecurity, product or service in any jurisdiction; nor is it intended to provide investment, financial, legal, accounting, tax, or other advice and such information should not be relied or acted upon for providing such advice. This document is not available for distribution to investors in jurisdictions where such distribution would be prohibited. RBC GAM is the asset management division of Royal Bank of Canada (RBC) which includes RBC Global Asset Management Inc., RBC Global Asset Management (U.S.) Inc., RBC Global Asset Management (UK) Limited, RBC Global Asset Management (Asia) Limited, and BlueBay Asset Management LLP, which are separate, but affiliated subsidiaries of RBC. In Canada, this document is provided by RBC Global Asset Management Inc. (including PH&N Institutional) which is regulated by each provincial and territorial securities commission with which it is registered. In the United States, this document is provided by RBC Global Asset Management (U.S.) Inc., a federally registered investment adviser. In Europe this document is provided by RBC Global Asset Management (UK) Limited, which is authorised and regulated by the UK Financial Conduct Authority. In Asia, this document is provided by RBC Global Asset Management (Asia) Limited, which is registered with the Securities and Futures Commission (SFC) in Hong Kong. Additional information about RBC GAM, Prospectus and Key Investor Information may be found at www.rbcgam.com. This document has not been reviewed by, and is not registered with any securities or other regulatory authority, and may, where appropriate and permissible, be distributed to institutional investors by the above-listed entities in their respective jurisdictions. Any investment and economic outlook information contained in this document has been compiled by RBC GAM from various sources. Information obtained from third parties is believed to be reliable, but no representation or warranty, express or implied, is made by RBC GAM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC GAM and its affiliates assume no responsibility for any errors or omissions. Opinions contained herein reflect the judgment and thought leadership of RBC GAM and are subject to change at any time. Such opinions are for informational purposes only and are not intended to be investment or financial advice and should not be relied or acted upon for providing such advice. RBC GAM does not undertake any obligation or responsibility to update such opinions. RBC GAM reserves the right at any time and without notice to change, amend or cease publication of this information. Past performance is not indicative of future results. With all investments there is a risk of loss of all or a portion of the amount invested. Where return estimates are shown, these are provided for illustrative purposes only and should not be construed as a prediction of returns; actual returns may be higher or lower than those shown and may vary substantially, especially over shorter time periods. It is not possible to invest directly in an index. Some of the statements contained in this document may be considered forward-looking statements which provide current expectations or forecasts of future results or events. Forward-looking statements are not guarantees of future performance or events and involve risks and uncertainties. Do not place undue reliance on these statements because actual results or events may differ materially from those described in such forward-looking statements as a result of various factors. Before making any investment decisions, we encourage you to consider all relevant factors carefully.

® / TM Trademark(s) of Royal Bank of Canada. Used under licence.

© RBC Global Asset Management Inc., 2021

Publication date: March 2022

Global Asset
Management