Mid-Year Sustainable Food Review

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I. Summary

Our update explores the challenges faced by sustainable food equities over the past year. Despite these hurdles, the industry's mid-cap bias and high allocation to sectors such as materials and industrials position it well to benefit as we move towards a period of recovery and expansion in the economic cycle. We view food valuations as attractive given recent challenges and believe innovative advancements and policy support could also drive earnings growth moving forward.

II. Why Have FOOD Equities Struggled in The Last Year?

We recognise food transition equities have faced challenges in a tough market environment. Following our analysis of Q1 2024 earnings calls for FOOD companies, we identified three key challenges that are cyclical in nature: Rising input costs, high financing costs and supply chain disruptions.

Rising Input Costs:

- FMC Corp and Lamb Weston Holdings experienced significant challenges due to rising input costs. FMC Corp reported a 32% decline in revenue in Q1 2024, largely attributed to ongoing cost pressures affecting sales volumes.
- Similarly, Lamb Weston Holdings faced higher costs for raw materials such as potatoes and oil, which strained profit margins and impacted overall financial performance.
- Despite these challenges, both companies remain optimistic. FMC Corp expects a rebound in the second half of the year driven by new product launches and market recovery. Meanwhile, Lamb Weston Holdings has raised its annual net sales target, driven by favourable pricing and an improved customer and product mix.
- As cost pressures ease and market conditions stabilise, food companies are well-positioned to recover and grow.

FMC Q2 2024 Financial Outlook

Revenue Drivers	
• Volume growth across all regions except Asia • Mid-single digit pricing pressure • Minor FX headwind	• Strong growth from new products including Coragen® eVo insecticide in Argentina and the U.S., Premio® Star insecticide in Brazil and Adastrio fungicide in the U.S.
ADJ. EBITDA Drivers	
• High volumes • Lower price • Minor FX tailwind	• Lower operating costs from restructuring • Favourable input costs more than offset by other COGS headwinds

High Financing Costs:

- Debt and high financing costs have posed significant challenges for companies, Americold Realty Trust, with a total net debt of $3.2 billion, has faced inflationary pressures that impacted cost structures and operational efficiency.
- Despite these challenges, Americold's financial position remains strong, with substantial liquidity of $732.5 million. The company is also investing heavily in new development projects, which are expected to drive future growth. It has raised full-year AFFO per share guidance, indicating a positive outlook for improved earnings.
- These financial pressures are expected to ease as market conditions improve, allowing companies to capitalise on strategic investments and drive growth.

Supply Chain Disruptions:

- Supply chain disruptions have significantly impacted companies like John Bean Technologies and Ball Corp.
- John Bean Technologies discussed higher costs of raw materials but also logistical delays, which hindered operations and slowed the integration of new automation technologies.
- Ball Corp struggled with securing enough aluminium and other essential materials, complicating production schedules and increasing costs.
- Despite these disruptions, both companies have a positive outlook for future earnings. John Bean Technologies is focusing on strategic pricing adjustments and new product launches to drive revenue growth, while Ball Corp is investing in capacity expansion and strengthening supply chain resilience.
- As these supply chain issues are resolved, companies are expected to enhance their operational efficiency and profitability.
- Whilst these factors have combined to create a cyclical downturn and led to operational difficulties, their effects should be short-lived and earnings call analysis reveals that many of our companies do not expect them to negatively impact future earnings.

III. Adversity to Advantage: The Road to Recovery And Growth

We've long discussed the environmental challenges of the food system and the potential benefits for investors arising from the global shift towards promoting long-term food security and stability. We now expect to see further support for sustainable food equities as we move towards a period of recovery and expansion in the economic cycle. This should also fuel further innovation which we expect to drive growth.

Why are Food System Equities Cyclical?

- Sustainable food equities are cyclical due to their particularly close (when compared to equities more generally) ties to broader economic conditions and consumer behaviours.
- During economic expansions, consumer confidence and disposable income typically rise, leading to higher demand for sustainably produced food. Conversely, during economic downturns, consumers prioritise cost over sustainability, which reduces demand.
- Additionally, sustainable food systems are capital intensive and require significant investments in technology, both of which tend to be cut back on during tougher economic times, further influencing the cyclical nature of these equities.

Why Do We Expect Them to Benefit Now?

- Recent developments suggest we are transitioning from the downturn phase of the economic cycle towards a period of recovery and expansion. We see this benefiting FOOD companies through two mechanisms:
  1. Operational Performance: Consider falling interest rates, these reduce the cost of borrowing, making it easier for companies to invest in sustainable practices and technologies. This can lead to innovation and improvements in efficiency, reducing costs over time and making sustainable food options more competitive. Moreover, lower interest rates can stimulate overall economic activity, boosting consumer confidence and spending power, which in turn increases demand for sustainably produced food.
  2. Capital Flows: Falling interest rates often lead to higher valuations for equities. Investors seeking better returns in a low-interest-rate environment may be more inclined to invest in equities. This influx of investment can provide the necessary capital for sustainable food companies to expand operations, innovate, and improve their market positions, ultimately supporting a recovery in these equities.

How Artificial Intelligence Disrupts Traditional Food Systems

"'Carto' is a futuristic complement to our ancient craft allowing us to experiment with formulas more easily and effectively. Perfumers can use the new tool to create more freely allowing us to push the boundaries for fragrance creation."

- We expect innovation within the sustainable food space will continue to drive advancements and growth.
- As an example, Givaudan SA (which is in our Ingredients, Flavours and Fragrances sector) has been leveraging A.I. in various aspects of its business, including flavour development. Its "Carto" system enables perfumers to use a touchscreen interface to select which raw materials they wish to mix. A robot then produces an instant sample, using real ingredients and A.I. to suggest a potential formula. This occurs at a speed that would be impossible using traditional methods.
- John Deere (Precision Agriculture) has harnessed A.I. to transform the agricultural sector by incorporating advanced technologies into its farming machinery. A.I.-driven systems enable precision agriculture by analysing vast amounts of data collected from fields to optimise planting, fertilisation, and irrigation processes. This technology includes autonomous tractors, smart sprayers that reduce pesticide use by targeting specific weeds, and real-time crop monitoring systems that assist farmers in making informed decisions.

Finally, we would like to highlight a recent political development that should provide supporting capital flows:

The US Farm Bill (June 2024)

- The Farm Bill is a comprehensive piece of legislation that guides agricultural policy in the United States. It encompasses a range of issues from food assistance programs and crop insurance to conservation efforts and agricultural research. Since its enactment in 1933, the bill has been renewed roughly every five years, yet the 2018 Farm Bill remains long overdue!
- Congress is in the process of reauthorising the bill, however there is debate over how to best allocate funds earmarked for "Climate Smart Agriculture" which involves the implementation of technology to improve crop yields and minimise resource inputs. Democrats support the existing $USD 20 billion in Inflation Reduction Act funding for United States Department of Agriculture conservation programs promoting practices like cover cropping and regenerative farming. However, Republicans are pushing to reallocate these funds into the Farm Bill, broadening its eligibility to include traditional conservation activities.

→ Whichever path is eventually taken, there must be continued focus on allocating funds towards innovation, research, and development in agriculture. This will foster new technologies and industrial policies capable of reducing emissions whilst boosting crop yields. The current extension of the 2018 Farm Bill is set to expire on September 30, 2024, so time is running out to resolve these differences and secure the necessary funding for climate-smart agriculture initiatives.

→ Whilst these factors have combined to create a cyclical downturn and led to operational difficulties, their effects should be short-lived and earnings call analysis reveals that many of our companies do not expect them to negatively impact future earnings.

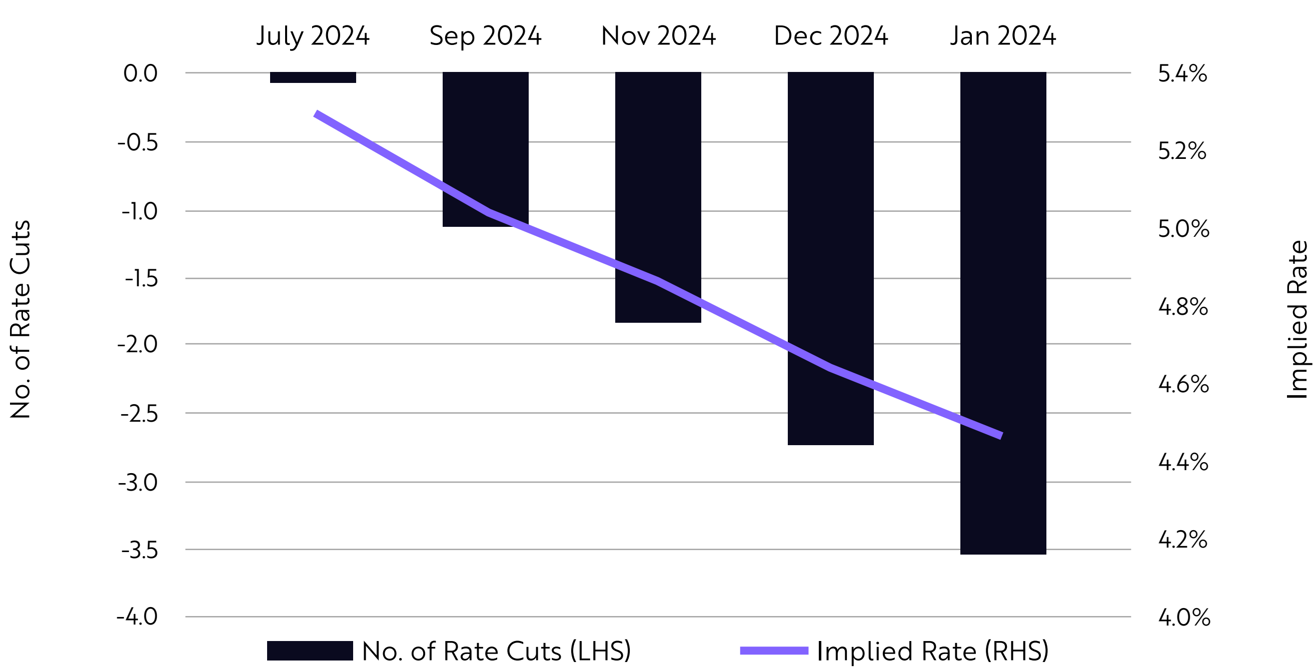
IV. Supportive Macroeconomic Backdrop and Broadening Out

In the previous section we discussed the positive impact of lower yields and rates on equities but particularly how these benefit sustainable food equities which are capital-intensive, innovative and highly resonant with the real economy and consumption patterns.

There is now mounting evidence that deflationary trends, as most recently evidenced by softer the June US CPI print, will prompt the Federal Reserve to cut rates.

At the time of writing, the market is pricing in almost 3 rate cuts by the end of the year with an expectation the Fed will start cutting in September.

Rate Cuts Priced in by US Futures Market



Source: Bloomberg, 16 July 2024.

Wall Street now expects to see a 'broadening out' effect as a wider range of equities, other than the tech megacaps that driven a significant chunk of broad market performance this year, will see price appreciation as they benefit from rate cuts:

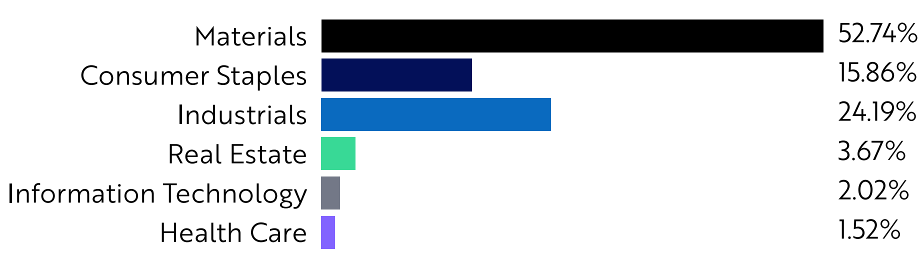
July 2024 Research Summaries

- Morgan Stanley – Expect the Fed to start cutting rates in September, which should provide a favourable environment for a wider range of stocks. Broader economic recovery should help the market expand beyond the Magnificent Seven stocks.
- Fundstrat (Tom Lee) – Bullish on the market broadening out. Highlights sectors such as energy, financials, and materials as potential gainers. Argues that economic fundamentals support a broader market rally, driven by improving corporate earnings and stable economic growth.
- Charles Schwab (Liz Ann Sonders) – Believes that for the bull market to broaden, there needs to be stability in monetary policy, easing inflation, and a calm bond market. Emphasizes importance of sectors like small-caps and financials performing better, which have typically lagged in the initial phase of the bull market.

Why is this exciting for Sustainable Food Equities?

- Sustainable food companies are well positioned to benefit from falling rates. They operate with small margins due to high competition, input costs, and the necessity to maintain affordable prices for consumers. Therefore, declining rates and inflation should provide a meaningful boost to bottom lines.
- We expect that consumers of, for example, tractors and fertilisers who have previously held back will benefit from a low-rate environment. This consumption boost should increase demand for such products, thereby improving earnings and profitability for sustainable food equities.
- Furthermore, our FOOD ETF has a 53% allocation to Materials and 24% allocation to Industrials, both sectors that typically benefit from the expansion phase of the economic cycle. Wall Street has also referenced Materials as one of the key sectors it expects to benefit this cycle from the rotation out of Tech megacaps.

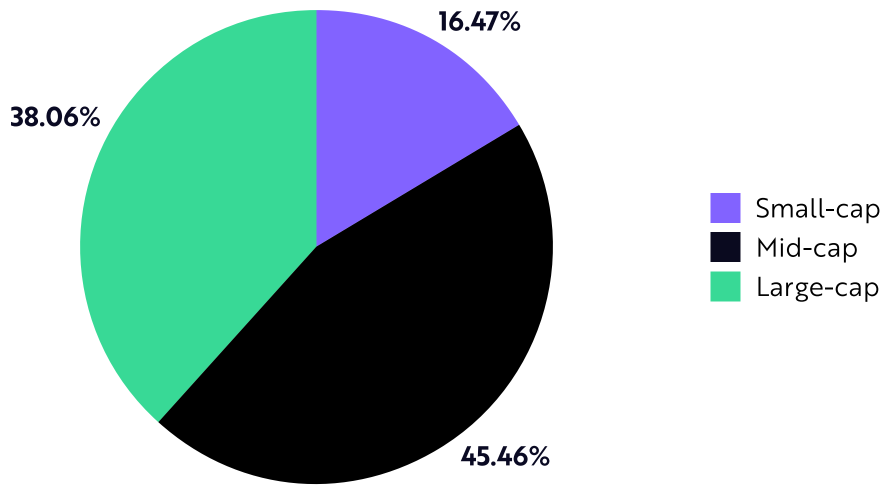
Rize Sustainable Future of Food UCITS ETF - GICS Sector Breakdown



Source: Bloomberg, 28 July 2024.

Finally, our FOOD ETF also has a mid-cap bias (45% by weight) and a 16.5% exposure to small-caps and is therefore well positioned to benefit from a broadening out of the rally in risk assets.

Rize Sustainable Future of Food UCITS ETF - Market Cap Breakdown



Source: Bloomberg, 28 June 2024.

How this Outlook Translates to Earnings Expectations?

- These favourable prospects, the overcoming of previous challenges and the constructive outlook for the sustainable food theme are evident through revenue and earnings expectations over the next three years. These are conservative forecasts based on consensus analyst estimates and adjusted to remove outliers.

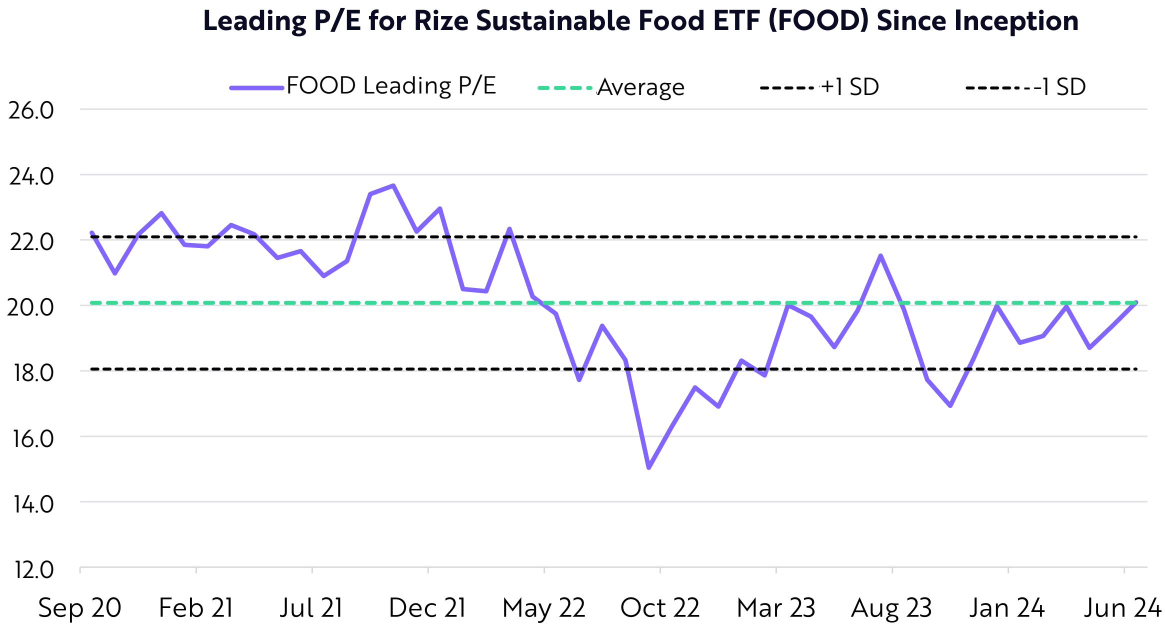
- Notably, these are the highest figures we have seen since we first ran this analysis in December last year. Earnings in each subsector are expected to increase by double-digits and overall at a rate of 15.99% per year over the next 3 years – higher than our previous 13.73% estimate from December.

Subsector	Forecast 3 Year Annualised Revenue Growth	Forecast 3 Year Annualised EPS Growth
Agricultural Science	**6.44%**	**15.55%**
Food Safety and Testing	**6.41%**	**17.44%**
Ingredients, Flavors & Fragrances	**5.13%**	**14.13%**
Plant Based and Organic Foods	**7.92%**	**18.34%**
Precision Farming	**7.39%**	**11.46%**
Supply Chain Technology	**7.82%**	**12.84%**
Sustainable Packaging	**4.47%**	**20.50%**
Water Technology	**5.57%**	**12.12%**
Overall	**6.38%**	**15.99%**

Source: Bloomberg, 28 June 2024. Outliers above the 95th percentile and below the 5th percentile have been removed.

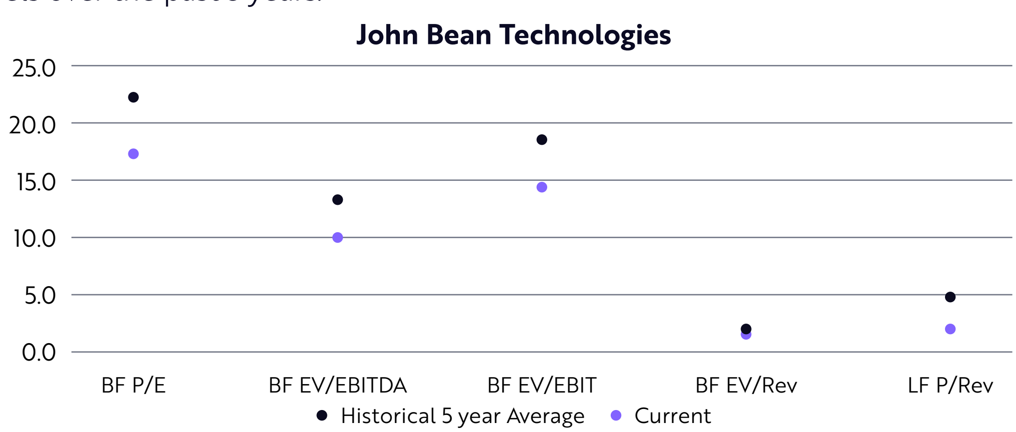
V. Food Stock Valuations

The chart below shows the forward-looking P/E ratio for FOOD since its launch in 2020. Despite earnings expectations increasing considerably as prospects improve, sustainable food equities have not rallied in a meaningful way and therefore remain attractively valued relative to historical norms.

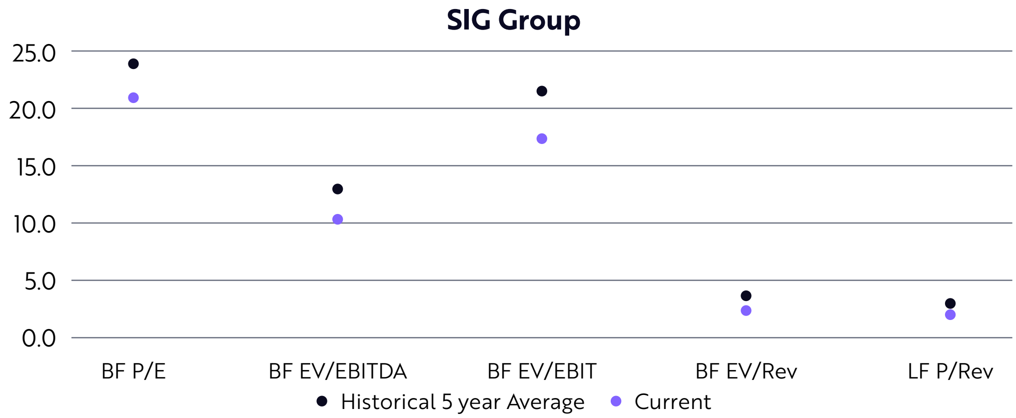


Source: Bloomberg, 28 June 2024. Where past performance and projected performance information is shown, it must be noted that past performance and projected performance is not a reliable indicator of future performance. Simulated past performance does not represent actual past performance and is not a reliable indicator of future performance. An investment in the fund involves significant risk and is subject to exchange rate fluctuations.

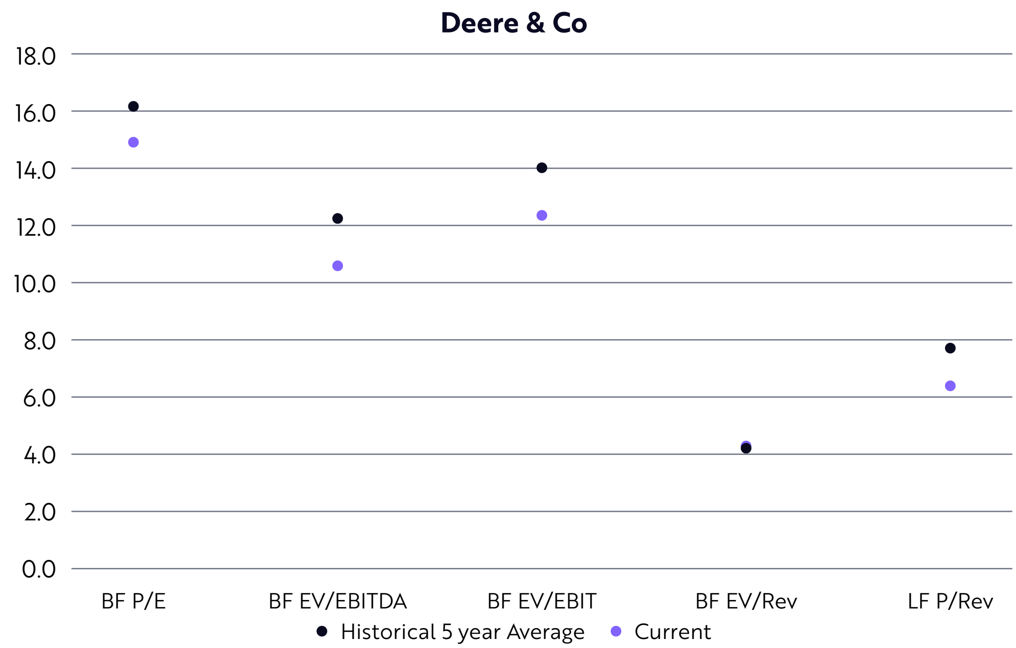
If we consider the valuations of individual companies, the picture is even more compelling. Many of our FOOD companies have a range of valuations metrics currently sitting far below their average levels over the past 5 years.



Source: Bloomberg, 17 July 2024.



Source: Bloomberg, 17 July 2024.



Source: Bloomberg, 17 July 2024.

Conclusion

We believe that sustainable food equities, despite recent challenges, are well-positioned for a period of recovery and growth, particularly given the sector's cyclicality and mid-cap bias. With supportive economic conditions, innovative advancements, and attractive valuations, the sector offers promising opportunities for investors.

About the Author

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Tom joined ARK in October 2021. As a Director and Senior Product Specialist, Tom works closely with clients and the sales team to promote an understanding of the ARK product range.

Prior to ARK, Tom was an ETF Product Strategist at Invesco and worked at Jupiter Asset Management as well as holding a Senior Analyst position at alternative assets data provider Preqin. Tom is a CAIA charter holder and a graduate of Newcastle University with a Bachelor of Arts in Economics.

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