Marfrig-Minerva deal: decoding the wood from the trees

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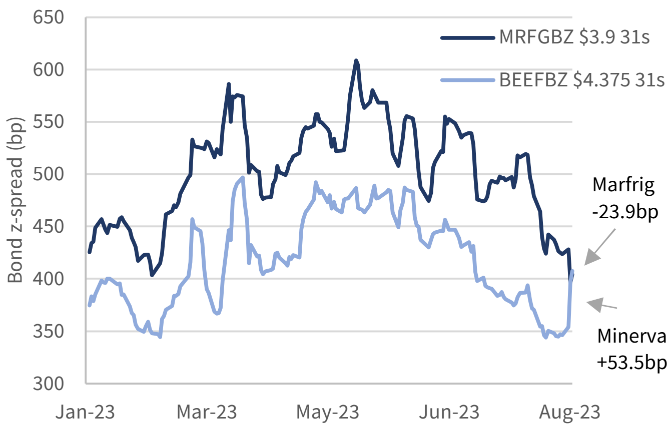
A new M&A transaction is set to take place in a controversial sector exposed to deforestation risk in South America.[1] It has just been announced that Brazilian meat-processor Minerva has agreed to buy cattle slaughtering and deboning facilities from Marfrig in a BRL 7.5bn deal ($1.53bn). The deal will boost Minerva's share of Brazilian beef export to 35% from 20% and is seen as transformational by analysts.[2]

We see some relative differences between the sustainability plans for Marfrig and Minerva, with this deal transferring a controversial asset into less responsible hands. Marfrig is committed to eliminating both legal and illegal deforestation in its supply chains. However, Minerva's deforestation commitments focus exclusively on illegal deforestation.

Figure 1. Marfrig (Ticker MRFGBZ) and Minerva (Ticker BEEFBZ) USD bond spreads, and daily moves on announcement of the deal. Source: Bloomberg, accessed 30



The market reaction to the transaction suggests investors are sceptical. Minerva shares slumped by 16% on the day following the announcement. Minerva's USD bond (rated BB) $4.375 31s widened by 53.5bps over increased leverage concerns, and Marfrig's bond (rated BB+) MRFGBZ $3.9 31s tightened by 23.9bps.

There are three main takeaways:

- **Minerva is rated with higher environmental risk than Marfrig, for whom the sale represents a re-focus on other activities. The assets to be transferred under the transaction will now be owned by an organisation committed to eliminating not all but only illegal deforestation in its supply chain, which increases overall environmental risks.**
- **Minerva spreads have already widened upon the announcement of the deal, but we see further risks coming from costs associated with recent EU deforestation regulation. Investors should conduct due diligence on Minerva's plans for complying with the regulation.**
- **The size of the combined operations also risk being subject to investment exclusions, as trends towards divesting from cattle-related deforestation increase.**

[1] For precedents, see "Bunge-Viterra merger: an ESG analysis", AFII, 14 Jun 2023.
[2] "Minerva's $1.5 Billion Deal Creates a South America Beef Giant", Bloomberg, 29 Aug 2023.

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A deal creating a South America beef giant

Leading Brazilian meat-processor Minerva has agreed on the 28th of August 2023 to acquire 16 slaughtering and deboning plants from Marfrig for BRL 7.5bn ($1.54bn). The transaction will increase Minerva's slaughter capacity by 12.9k heads of cattle and 6.5k heads of lamb per day (a 43% capacity increase compared to its actual production). After the acquisition, Minerva will have 21 units in Brazil, five in Paraguay, six in Argentina, six in Uruguay, and two in Colombia. Its lamb business will have five plants, four plants in Australia and the new site in Chile.[3]

Minerva has already paid BRL 1.5bn for the acquisition. JPMorgan Chase & Co. has committed to providing a bridge loan for the rest of the transaction,[2] which may be refinanced with a bond deal.

JPMorgan Chase & Co.'s environmental policy does not prohibit the bank from being involved in such a transaction, which stands in sharp contrast with the industry's trend towards adopting stricter deforestation policies.[4] However, an "*enhanced review to facilitate a comprehensive understanding of the transaction and associated risks*" is required for non-US clients involved in beef products.[5]

The transaction will be a partial exit for Marfrig from a controversial sector that is a primary driver of deforestation in South America [6] and is part of the company's strategy to focus on value-added products and processed foods.[2] It is estimated that Marfrig's revenue in the region is set to decline by 43% to BRL 15.8 bn.

The deal is set to create a beef giant in the region, potentially leading Minerva to seek funding through the public bond market at a later stage.

JP Morgan's participation in a deal with high deforestation implications could spread doubts about the appropriateness of the bank's environmental policies.

Shifting the deforestation risk

Both Minerva and Marfrig have clear potential to improve their environmental footprint. According to Trase, Minerva has the largest deforestation exposure associated with beef in Paraguay (364,542 ha) and the second largest in Brazil (108,835 ha). Marfrig ranks third in terms of deforestation exposure in Brazil (63,949 ha).[7] Under the current terms of the deal, we can roughly estimate that Minerva's Brazilian deforestation footprint will double after the deal's completion.

The sale will concentrate production in Minerva's hands, where their production will account for more than a third of frozen beef exports to the EU. [8] The deal also holds greenhouse gas emissions implications. Minerva's total emissions currently sit at 18 MtCO2e, amongst which 98% originate from scope 3 emissions, mainly from enteric fermentation of cattle raised on suppliers' farms.[9]

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[3] "Minerva buys beef assets from Brazilian peer Marfrig", Just Food, 29 Aug 2023.
[4] Examples: Barclays' "Forestry & Agricultural Commodities Statement – April 2023" and Citi Group's "Environmental and Social Policy Framework – March 2023", accessed 30 Aug 2023.
[5] See JP Morgan Chase & Co's 2022 "Environmental Social Governance Report", accessed 30 Aug 2023.
[6] "The state of forest-risk supply chains - Trase Yearbook 2020", Trase, July 2020.
[7] See Minerva SA and Marfrig Global Foods SA deforestation profiles on Trase, accessed 30 Aug 2023.
[8] "Regulation (EU) 2023/1115 Of the European Parliament and the Council", Official Journal of the European Union, 31 May 2023.
[9] "Global greenhouse gas emissions", Minerva foods, accessed 30 Aug 2023.

With a 43% increase of its slaughtering capacity, we can estimate that the company's emissions will rise to around 25M tCO2e.

When trying to analyse what differences there are between the two companies' environmental performance, we see a few points of note.

Both companies have been given a score of 2/5 by Forest500,[10] reflecting the weakness of their commitments to tackle deforestation in their supply chains, however Investor initiative FAIRR (Farm Animal Investment Risk & Return) which monitors ESG issues in the protein industry assigned Marfrig to the "Low risk" category and Minerva to the "Medium risk" one.[11]

Marfrig has made commitments to ending legal and illegal deforestation in its supply chain,[12] compared to Minerva's commitments which only address illegal deforestation.[13] The recently adopted EU regulation on deforestation-free products will require companies exporting key commodities such as cattle to the EU to prove their products are not associated with either legal or illegal deforestation,[8] confirming the importance of addressing both types. Although Marfrig cannot currently monitor all its indirect suppliers, its commitment to address both illegal and legal deforestation increases its likelihood to comply with the regulation compared to Minerva.[14]

Marfrig's motivation in the sale also suggests some intention to adjust their business mix to focus on more value-added products and processed food.[2] The deal places Marfrig in a more favourable position than Minerva as it transfers the risk of assets highly exposed to deforestation over to Minerva. We note Marfrig has issued a sustainable transition bond,[15] advertising commitments to improving the sustainability of their production process. We recognise it is very hard to evidence improvements, but there seem some more positive intentions from Marfrig compared to Minerva.

This asset sale seems to be moving to a less responsible owner, with poor commitments to improving sustainability.

The deal brings substantial deforestation implications for Minerva investors. It increases the company's exposure to a controversial sector facing escalating regulatory risks with little guarantee that the company will meet regulatory requirements.

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[10] See Minerva SA and Marfrig Global Foods SA Forest500 scores, accessed 30 Aug 2023.
[11] FAIRR Initiative – Company Ranking, accessed 30 Aug 2023.
[12] "Marfrig commitment", Marfrig, 23 Jul 2020.
[13] "Minerva foods – 2022 Sustainability report", Minerva, accessed 31 Aug 2023.
[14] "JBS, Marfrig, and Minerva Unlikely Compliant with Upcoming EU Deforestation Law", Chain Reaction research, Nov 2022.
[15] "Marfrig shakes-up sustainable finance with beef bond", The Banker, 2 Jan 2020.

Recent bond performance

Marfrig (Ticker MRFGBZ) and Minerva (Ticker BEEFBZ) are both high-yield rated issues, with USD and BRL bonds outstanding. A full list of outstanding bonds is shown in Table 1.

Table 1. Marfrig and Minerva outstanding bonds. Source: Bloomberg, accessed 30 Aug 2023.

Description	ISIN	Issue Date	Maturity	Currency	Coupon	Rating	Amount Outstanding
MRFGBZ $7 26s	US62877VAA98	14-May-19	14-May-26	USD	7	BB+	784,000,000
MRFGBZ $6.625 29s	US62877VAB71	06-Aug-19	06-Aug-29	USD	6.625	BB+	487,000,000
MRFGBZ $3.9 31s	US566007AC41	29-Jan-21	29-Jan-31	USD	3.9	BB+	1,256,000,000
MRFGBZ BRLFloat 26s	BRMRFGDBS036	28-Jan-22	15-Jan-26	BRL	Float		500,000,000
MRFGBZ BRLFloat 27s	BRMRFGDBS051	11-Nov-22	11-Nov-27	BRL	Float		600,000,000
BEEFBZ $5.875 28s	US603374AE94	19-Dec-17	19-Jan-28	USD	5.875	BB	182,267,000
BEEFBZ $4.375 31s	US603374AF69	18-Mar-21	18-Mar-31	USD	4.375	BB	1,291,191,000
BEEFBZ BRLFloat 26s	BRBEEFDBS057	21-Oct-21	15-Oct-26	BRL	Float		400,000,000

Figure 2 shows the spread moves for the USD bonds since the transaction was announced, and Figure 3 shows historic spread levels for the two longest dated USD bonds. Despite Marfrig's one notch higher rating,[16] we observe that prior to the announcement of the deal MRFGBZ $3.9 31s was trading around 70bp wider than BEEFBZ $4.375 31s, the closest equivalent bond, despite similar coupons and maturities. Since the transaction was announced on 28 Aug 2023, Marfrig's spreads have tightened and Minerva's spreads have significantly widened, likely as a result of reducing / increasing leverage, respectively, due to the asset transfer.

Figure 2. MRFGBZ and BEEFBZ USD bond spreads from 25 Aug 2023 (crosses) to 30 Aug 2023 (circles). Source: Bloomberg, accessed 30 Aug 2023.

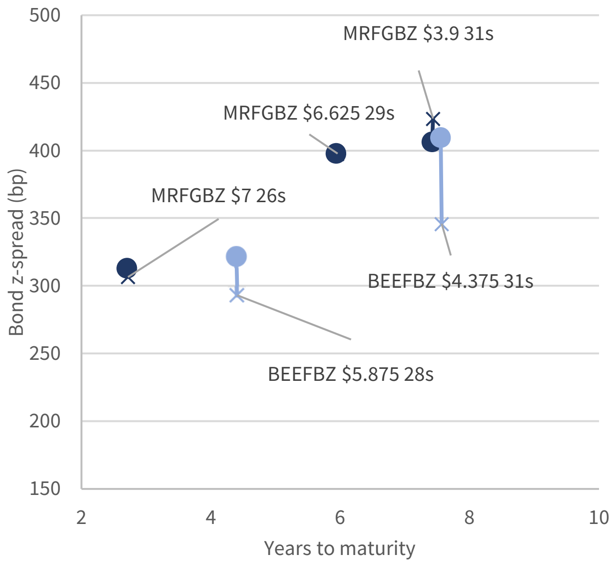
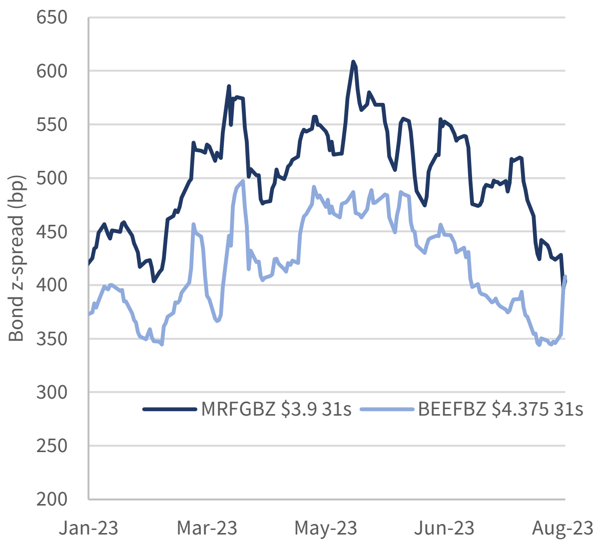


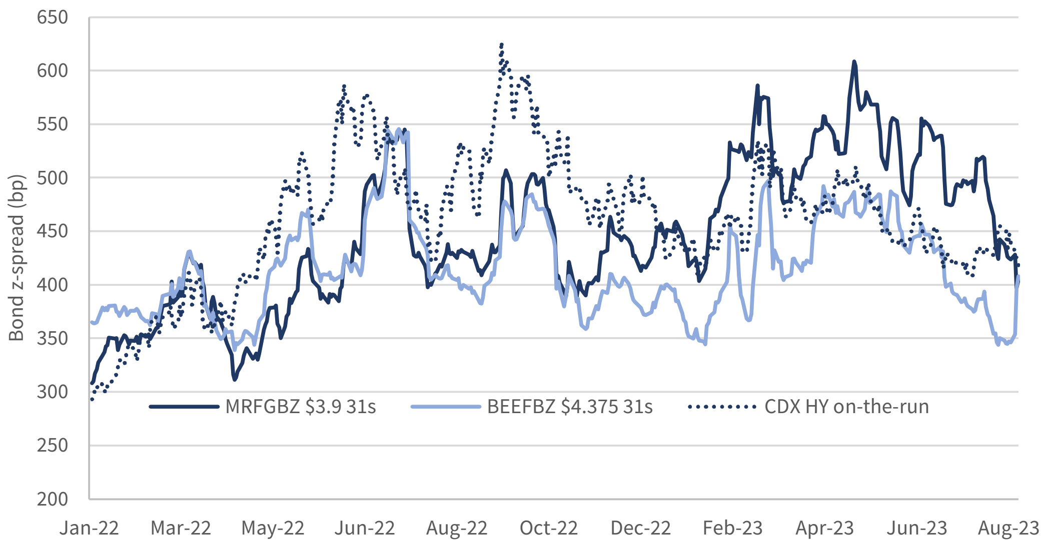
Figure 3. MRFGBZ and BEEFBZ historic USD bond spreads. Source: Bloomberg, accessed 30 Aug 2023.



[16] Which has been confirmed by S&P taking account of the asset purchase, see "S&PGR Affirms 'BB' Rtgs on Minerva S.A., Outlook still stable", Bloomberg, 30 Aug 2023.

Recent EU deforestation regulation, where only products exposed to key commodities that can prove they do not contribute to deforestation can be sold in the EU, will have a significant impact on the Brazilian cattle industry.[17] It has been reported that both Marfrig and Minerva are unlikely to be compliant, and so will either incur costs to comply, or fines and lost revenue for non-compliance.[14] Figure 4 shows historic bond spreads since the start of 2022 compared with CDX HY spread (the index, with a rolling 5y maturity). We see no dramatic shift in 2023, suggesting an underperformance of these bonds compared to the index; therefore, we believe these ongoing costs are unlikely to have been priced in. This presents further price risk for both issuers, but more specifically Minerva which is increasing its exposure in this area due to the asset purchase.

Figure 4. MRFGBZ, BEEFBZ and CDX HY historic spreads. Source: Bloomberg, accessed 30 Aug 2023.



Since the announcement of the deal, there has been volatility in the bond spreads, likely driven by the leverage changes due to the asset sale. However, we see further risks for Minerva spreads coming from exposure to recent EU deforestation regulation.

Deforestation investment exclusions

A popular 'entry-level' sustainable investment strategy is to exclude investments in a defined list of undesirable activities. The impact of being included in such a list, either by changes in business-mix for an issuer,[18] or changes in policies for investors, [19] can be significant, and should be anticipated by bondholders.

Deforestation is a theme increasingly being considered by investors for exclusion. Initial focus tends to be on Palm Oil linked destruction, but can also be extended to other products including cattle. Divestment has been threatened by some large investors, although it has not necessarily yet been followed-through on.[20] We observe some investment policies have made commitments to exclusions, for example Axa Investment Management excludes companies with controversial

[17] "Parliament adopts new law to fight global deforestation", European Parliament News, 19 Apr 2023.
[18] For an example please see "ConocoPhillips crossing oil sands exclusion thresholds", AFII, 16 Aug 2023.
[19] For more background please see "Arctic oil & gas: left out in the cold", AFII, 26 Apr 2023.
[20] "Asset managers fail to act on pledges to divest from Brazil over deforestation", FT, 2 Dec 2021.

practices in Land Use for soy, cattle and timber.[21] Some investors have already implemented exclusions in the sector, for example Danske Bank has excluded Minerva for Biodiversity impacts,[22] and Norges Bank has Marfrig on observation for Severe Environmental Damage.[23]

Minerva's increased deforestation footprint, on completing this acquisition, is at risk of falling into the scope of more exclusion policies, as the magnitude of the environmental impact becomes harder to ignore.

Investor divestment would be negative for bond prices, and so potential exclusions should form part of bond holder due diligence.

Conclusions

Minerva's purchase of slaughtering houses from Marfrig creates a beef giant in South America, for which financing may need to be raised to re-finance a bank bridge loan.

Despite this being an environmentally controversial sector, we see some differential between the sustainability performance of the two companies. Marfrig has made some positive signs including focusing on both legal and illegal deforestation and issuance of a sustainability bond, whereas Minerva has committed only to eliminate illegal deforestation. With that in mind, we view the asset sale as moving into less responsible hands.

Bond pricing has been volatile since the announcement of the deal, with Minerva widening and Marfrig tightening, likely due to anticipated leverage changes. We see further risks for Minerva spreads coming from recent EU deforestation regulation, which it is currently unlikely to be compliant with.

As a further challenge, the increased scope of Minerva's activities is at risk of falling into the scope of ongoing trends towards investment exclusions for deforestation, which would put further pressure on bond prices.

[21] "Responsible Investing", AXA IM, Feb 2023.
[22] "Excluded Investments", Danske Bank, Jul 2023.
[23] "Observation and exclusion of companies", Norges Bank Investment Management, accessed 30 Aug 2023.

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