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Danone's dismissal of its CEO: risk-return trade-off or risk-return-sustainability tripod? The inclusion of sustainability in the financial equation

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Danone’s dismissal of its CEO: risk-return trade-off or risk-return-sustainability tripod? The inclusion of sustainability in the financial equation

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Abstract

In March 2021, the CEO of Danone, well known for his commitment to sustainability, was dismissed due to poor financial performances. Drawing on this apparent opposition between financial and non-financial indicators, we introduce a risk-return-sustainability tripod to analyse this decision from the shareholders' point of view. We show that even for a “responsible” shareholder, financial indicators still matter, and that an equilibrium is required between the three parameters of the tripod. By applying this tripod to two different sectors, we show that various shareholder segments can co-exist in a company’s capital.

Keywords: financial performance; risk; return; sustainability; Danone.

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A risk-return-sustainability tripod: the case of Danone shareholders

On 15 March 2021, Emmanuel Faber was removed from his position as CEO of the Danone group. For several years, this executive had been directing Danone's strategy towards greater sustainability and increased compliance with ESG (environmental, social and governance) criteria. His dismissal from the management of the Danone group sounds like a punishment: is it possible to lead a large group along the path of sustainable development without displeasing shareholders? To what extent does his dismissal have to do with sustainability concerns?

1. The news story and reactions from the press

As soon as the Danone group published its press release, analysts and journalists sought to understand the reasons behind Emmanuel Faber's dismissal. The first thing that was mentioned was not an explanation, but rather an observation: Emmanuel Faber had never made a mystery of his desire to work towards a fairer world by working in a meaningful job. In 2012, he published a very personal book in which he looked back on his history to explain what he believes in and, above all, what he does not believe in: profit for profit's sake, without concern for human values. Two years later, after he was appointed head of the Danone group, he gradually launched several environmental and social initiatives, including the creation of innovation funds for food health and aid for disadvantaged populations. In June 2020, he obtained a 99% majority shareholder vote to make Danone a mission-driven company, the first of its kind within the French CAC 40 index. In early 2021, an activist investment fund (Bluebell Capital) caused a stir, not only by declaring that it had taken a stake in Danone, but also by publicly demanding that Danone's charismatic CEO be replaced. Indeed, Bluebell Capital - soon to be joined by Artisan Partners - lamented Danone's poor financial performance compared to its direct competitors, Unilever and Nestlé. After a few weeks of reflection and meetings between Danone's directors, the news finally broke: Emmanuel Faber was to leave his position as CEO immediately and be replaced by another director. For most of the economic press, the observation was quite simple: the shareholders of a group are ready to move towards greater sustainability and to put forward ESG criteria... as long as this does not jeopardise the financial performance of the company! However, to implement a policy aligned with the sustainable development objectives (SDO), a company must necessarily commit money, which will therefore impact its short-term performance. Danone's shareholders therefore faced criticism for two things: on the one hand, for not having had the patience to wait for a return on investment from a societal and environmental policy; on the other hand, for not having been able to see beyond the quest for financial profitability alone.

2. Activist funds and shareholders

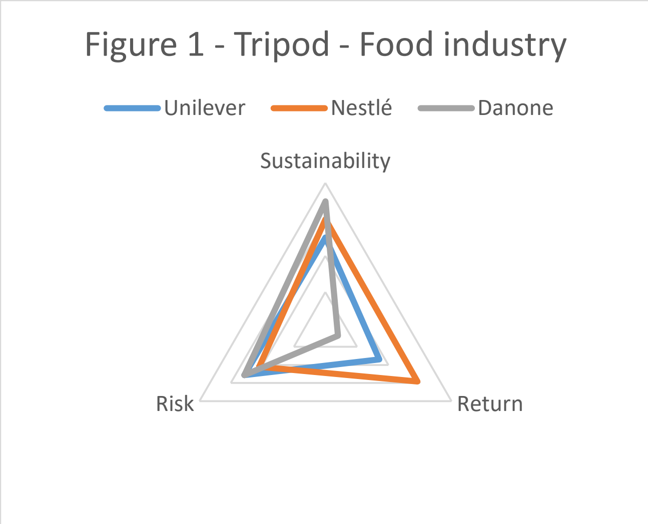
In most of the reactions to this news, the two activist funds are lumped together with all the shareholders. However, these investment funds are used to acquiring shares in companies in which they wish to bring about a rapid change, in order to increase the company's share price and thus realise a capital gain. They therefore work within a short-term rationale, which is not necessarily the case for most Danone shareholders. Nonetheless, it should be noted that these investment funds only hold a small share of the capital: less than 5% of the voting rights. They thus had to convince the other shareholders - to obtain a majority in a general meeting - or to contact the directors directly - if they wished to avoid the complications and publicity of a general meeting with a motion to resign.

In the case of Danone, Emmanuel Faber's departure was voted in by the board of directors by 10 out of 16 directors. We must therefore assume that the investment funds succeeded in mobilising other shareholders to influence this decision, or that their arguments succeeded in convincing a majority of the group's directors. Thus, a first conclusion can be drawn from this story: the shareholders do not form a homogeneous group. In the same way that a marketing manager knows very well that his clientele consists in several distinct segments with different expectations, large companies have an interest in identifying the different categories of shareholders who hold their capital. One segment can deal with the time horizon. Indeed, there are the shareholders who demand regular performances quarter after quarter: oriented towards short-term performance, they are ready to sell their shares ("vote with their feet") as soon as the performance is no longer there. This is the case for many investment funds and hedge funds. Conversely, we have another category of shareholders who are prepared to wait patiently for the results of a medium- or long-term strategy. Another segmentation criterion can be the goal of the shareholders. Some shareholders seek to maximise their profits, according to the risk-return ratio, without worrying about any other criterion (we can call them "risk-return shareholders"); in contrast, other investors are prepared to include a third environmental and societal dimension in their choices. This means that this latter category no longer reasons solely on the basis of risk-return, but rather seeks the balance of a risk-return-sustainability tripod. In other words, this category of investors will accept lower profitability if this is compensated for by more ESG-oriented projects (we can call them "responsible shareholders").

It is therefore important for a company to know the geography of its capital. Indeed, many decisions are not taken by an absolute majority of voting rights: in many cases, there may be the equivalent of a swing state in the US electorate, i.e., a small group of individuals who will help to drive a decision one way or the other by the power of their vote alone. It is thus conceivable that if a small group of activists can get a CEO to resign on the basis of financial performance, then in other circumstances another small group of shareholders could just as easily redirect a group's strategy towards more sustainable development.

3. The risk-return-sustainability tripod

In the case of Danone, the activists did not particularly criticise Emmanuel Faber for his strategies towards more sustainability. They focused their arguments on the group's poor financial performance compared to that of its two main competitors: Danone's share price had risen by only 8% over the last five years, compared to +34% for Unilever and more than 58% for Nestlé (including dividends). But in parallel to these profitability figures, what about the level of risk and the degree of sustainability of each company? For profitability, as we have seen, we have used the increase in share price (including dividend) over the last five years. For risk, we use a classical measure of volatility in finance, i.e., the standard deviation of monthly returns for Danone, Unilever and Nestlé shares over the same five-year period. Finally, for the corporate sustainability criterion, we refer to the rating established by MSCI ESG ratings on a sample of 2,800 companies. On this last criterion, Danone is the best ranked of the three companies: it obtains an AAA rating, i.e., the best rating on a 7-level scale. Figure 1 proposes a graphical representation of this tripod for the three companies.



As can be seen in the figure, the three companies are roughly at the same level in terms of risk: this is not too surprising, as they operate in the same sector and customer segments.

In terms of ESG rating, the differences are small: Danone is rated AAA, followed by Nestlé (AA) and then Unilever (A), i.e., all three companies are in the top 3 levels of a 7-level scale. Finally, when it comes to profitability, this is where we see major differences. In the logic of a balanced tripod, one would expect the three triangles to occupy roughly the same area. In other words, an ESG deficiency for a company should be offset by better profitability, while a company active in sustainability might have lower profitability, but probably also lower risk. The idea of the tripod is precisely that of compensation and balancing between the three criteria. In this graph, we can see that Danone's triangle is much smaller (in terms of surface area) than that of the other two groups: despite a better environmental performance, and at roughly the same level of risk, the group has much lower profitability than the other two companies. In fact, if we only focus on Danone's history, the sustainability axis does not bring much added information here: indeed, in a classical risk-return trade-off, we can see that Danone is generating much less profitability than its main competitors, for approximately the same level of risk. In other words, and as opposed to what has been said in the press, sustainability concerns did not play much of a role in the shareholders' decision to dismiss Emmanuel Faber.

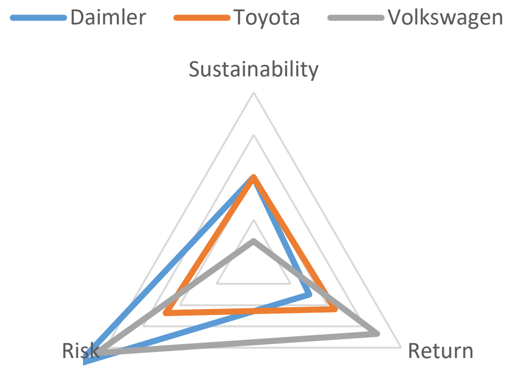
Coming back to figure 1, we can now focus on a one-to-one comparison with Unilever: this company has a lower ESG rating than Danone, by two notches. But once again, when a shareholder cares about ESG issues, this does not mean that this responsible shareholder will forget either risk or return in his appraisal. Unilever illustrates that this tripod is a matter of reaching equilibrium: for the same level of risk, even a responsible shareholder can opt for a lower ESG rating, if the higher return acts as a compensation. In other words, the Unilever triangle is more balanced than Danone's, from a shareholder point of view. As a conclusion, the popular view of Emmanuel Faber's dismissal proves to be wrong: he was not dismissed because of his push towards more sustainability, but mostly because the improvement in sustainability was not enough – even for responsible shareholders – to compensate for the drop in return. The ideal company, then, seems to be Nestlé: for the highest level of profitability, it also shows a lower level of risk, and a very good sustainability rating.

4. Extension to another industry and further analysis

Admittedly, this tripod chart may be considered simplistic. The indicators chosen – though corresponding to industry standards – can always be refined. Furthermore, most investors use many more criteria when deciding whether to invest in a company. But this figure has the merit of going beyond the traditional risk-return trade-off, by including a third, non-financial dimension.

This tripod could then be generalised to different sectors to provide a better understanding of shareholders' choices. After having applied this tripod to the Danone case and its food industry competitors, we opted for a very different industry: the automotive sector. Indeed, as opposed to the previous example where companies work and communicate on sustainability issues, the automobile industry does not have a good reputation with regard to ESG factors, especially the environmental part (pollution, carbon footprint, use of fossil fuels). We expect to be at the other end of the spectrum in terms of sustainability, which makes it interesting to investigate whether a small change in the sustainability rating can have an impact on the two other parameters of risk and return. In Figure 2, we show three major players in the automotive industry. It comes as no surprise to see that their ESG rating is lower than in the previous sector, with differences: Volkswagen, for example, is at the lowest level in terms of sustainability rating (CCC).

Figure 2 - Tripod - Car makers



Looking at the graph, we can see that one company has a balanced but small tripod: this is Toyota. This could be considered as a company attracting a good proportion of "responsible" shareholders, who are satisfied with a concern for sustainability, and who feel that their exposure to risk is correctly compensated for by a decent return. Comparatively speaking, the other two companies show a higher level of risk than Toyota, and they exhibit two different profiles. Volkswagen shows the highest profitability, at the expense of an extremely low ESG impact; on the contrary, Daimler has a higher ESG rating but exhibits lower profitability. This tripod thus helps us understand better the geography of capital for these three companies: Volkswagen shareholders tend to be mostly "risk-return" shareholders, operating only to maximize their return for a given level of risk; with the same level of risk, Daimler seems on the contrary to attract a higher proportion of "responsible" shareholders, who are ready to accept a lower return for a higher engagement towards sustainability issues; finally, Toyota shows a balanced "middle-of-the-road" profile: lower risk than the competitors; decent return; decent sustainability rating.
Though simple, this tripod can help visualize the key concerns of shareholders in different sectors. In each sector, we can then identify the companies operating in a classical risk-return strategy, and the would-be game-changers who succeeded somewhat in incorporating sustainability issues into their shareholders' agendas. Future avenues of research could consist in the following: mapping a cartography of all sectors; and connecting each company's tripod with its corporate announcements (i.e., letters to the shareholders), specifically to check the long term vs. short term horizon of the announced strategy, and its impact on shareholder activism.

5. Conclusion

By taking an example from the recent news, we have investigated whether shareholders' choices can go beyond the classical divide between the risk that is faced and the financial return that is requested. The introduction of a third criterion, that of sustainability, not only allows for a better understanding of the choices of different shareholder segments, but also enables us to debunk certain myths, for example the opposition between ESG concerns and shareholders' demand for maximized profitability. Indeed, in some cases like Danone, a strong commitment to sustainability is no excuse for a poor financial performance. In other cases, among different sectors, this risk-return-sustainability tripod helps to map the different segments of shareholders ("risk-return" v. "responsible") and their respective influence in the geography of the capital. As it turns out, this tripod leads to fundamental questions as regards the priority given to the three criteria in the CEO's agenda. It allows companies and investors to ask themselves the following questions: what kind of shareholders would I like to have, and how can I satisfy their demands? What type of company would I like to invest in, and what priority criteria should I use in my choice? We do not recommend that all companies try to reach a perfect equilibrium between risk, return and sustainability. Rather, we highlight the fact that if a company chooses to give priority to one of the three parameters, then it will probably change the equilibrium of this risk-return-sustainability tripod as compared to its main competitors, and attract shareholders whose interests are the most aligned with this new configuration.

References

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