Danone Company Analysis

Key Insights

1. Industry Overview
2. Top Line
3. Operational Performance
4. Capital Allocation
5. Corporate Governance

BREQ Capital

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https://youtu.be/-Weol3uEmHQ

1 Industry Overview

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Part of Danone's underperformance can be attributed to **unfavorable category dynamics** in its end markets rather than execution alone

Dairy and Plant-Based (EDP)

54% *% of Sales*

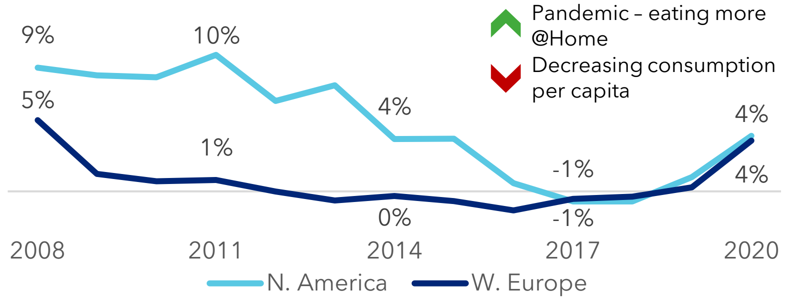
Danone's Main Markets (2021)

#1 ~**39%** of EDP Sales

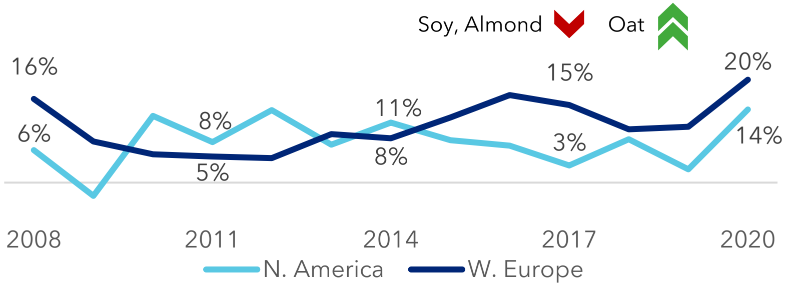
#2 ~**31%** of EDP Sales

Yogurt, Ice Cream, Cheese

Yogurt Retail Value Growth YoY (%)



Milk Alternatives Retail Value Growth YoY (%)



Plant-Based Dairy represented ~5% of the Global Dairy market in 2020, at $22.9 bn, but is estimated to grow to ~10% of it, at $62.3 bn in 2030

Specialized Nutrition (SN)

30% *% of Sales*

Danone's Main Markets (2021)

~75% of SN Sales

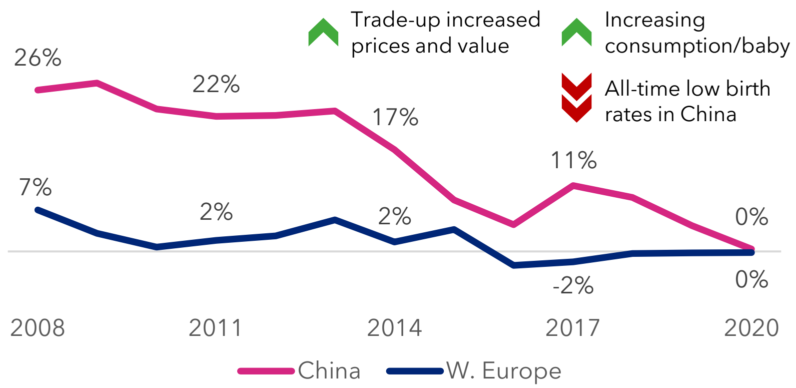
Infant Milk Formula (IMF)

#1 ~**38%** of Danone's SN Sales

premium

#2 <**28%** of Danone's SN ~**48%** of Global IMF

IMF Retail Value Growth YoY (%)



The low number of babies (0-3 y.o) had a **~5% negative effect**...
... in the Chinese IMF growth in 2019 and 2020

Negative consequences of increasing regulation in China...

Regulatory measures increased the competition from local Chinese players

Locals Market Share	
2019	2021
29% →	**44%**

Chinese Govt's Target of 50% Breastfeeding Ratio by 2025

Waters

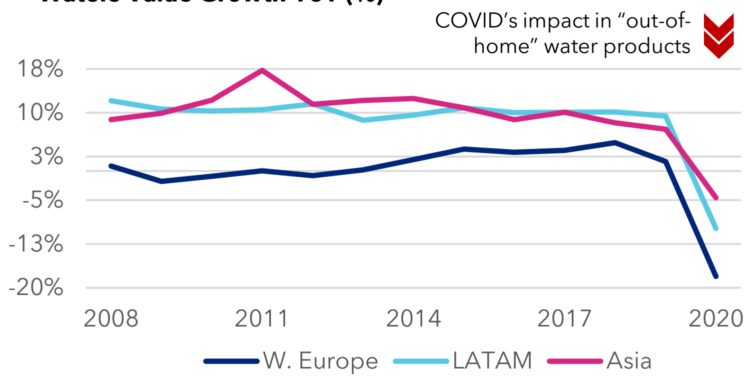
16% *% of Sales*

Danone's Main Markets (2021)

#1 ~**40%** of Danone's Water Sales

#2 AMEA, LATAM, CIS & TURKEY ~**39%** of Danone's Water Sales

Waters Value Growth YoY (%)



In 2021 "61% of UK consumers have reduced their **usage of single-use plastics**" to adopt a more sustainable lifestyle.
Deloitte.

Still, consumers' increasing concerns about sustainability are yet to reflect on the demand for plastic bottled water.

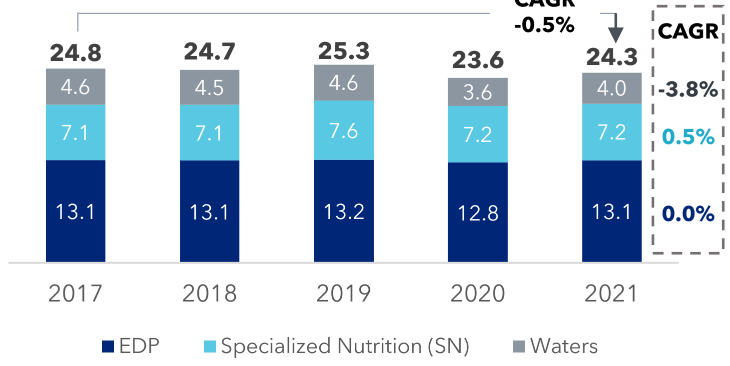
Source: Company Publications, Euromonitor, Nielsen, Bloomberg Intelligence, OECD, FAO, The Good Food Institute, a2 Milk Company Publications, JP Morgan Research, Deloitte

2 Top Line

Weak organic sales growth, below end markets growth, resulted in market share losses

1. Sales had a Slight Decline Between 2017-21

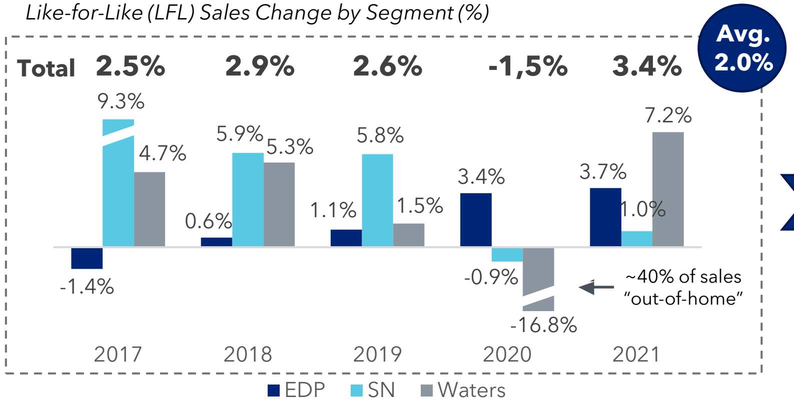
Reported Net Sales (€ billion) and CAGR (%)



Apart from **weak Like-for-Like (LFL) sales growth**, **FX** was the main reason for **poor top line performance**, with a negative impact of **~€3.2 bn** on the period. Danone has a strong presence in Emerging Markets, which have more volatile currencies

2. In a LFL Basis, Average Growth was Still Low at 2.0%

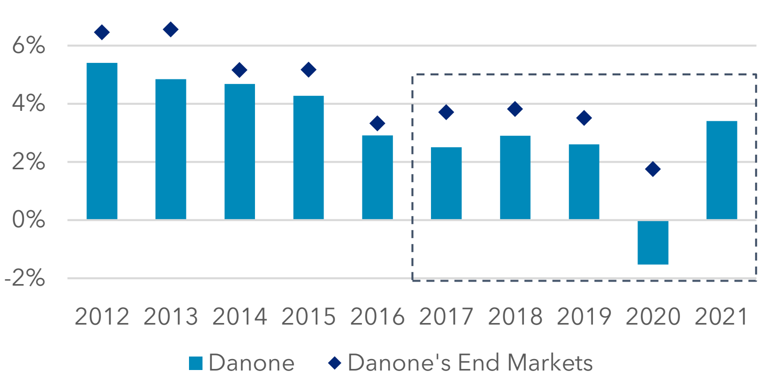
Like-for-Like (LFL) Sales Change by Segment (%)



Waters and SN were heavily impacted by the pandemic due to their high exposure to "out-of-home" formats and the Chinese market, respectively. Revenue growth sped up in EDP due to increased consumption of Yogurt and Dairy alternatives during the pandemic

3. Danone's Growth Remains Below End Markets'

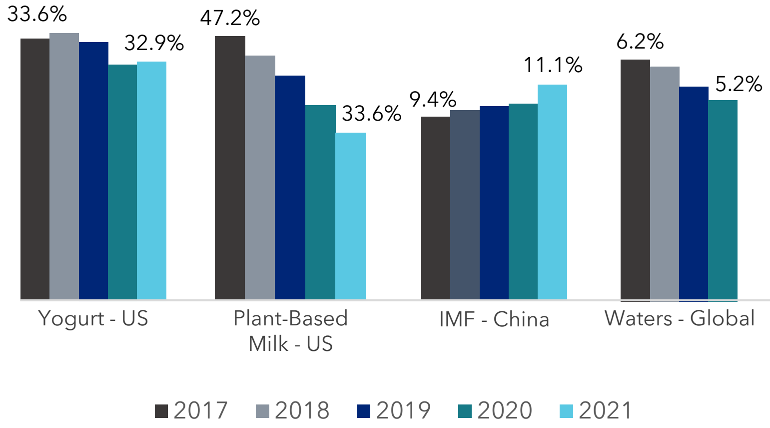
Like-for-Like (LFL) Sales Change vs 2012-20 End Markets Estimated Growth (%)



Even before the pandemic, Danone was showing lackluster growth, partially due to the **decelerating end markets**, but also to its **inability to grow in line with them**

4. Resulting in Market Share Losses in Some of its Main Categories

Danone's Market Share (%) by Product/Segment



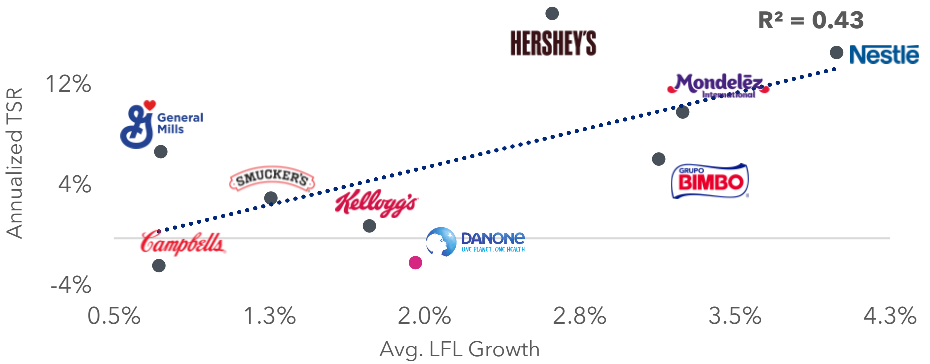
- Danone is losing share in the **US Yogurt** market to Chobani, which is using aggressive marketing campaigns and more product innovations…
- …with steeper share losses in **W. European Yogurt** markets;
- In the **US Plant-Based** market, share erosion comes from small players offering mainly Oat-based products;
- Danone over-indexes to Almond and Soy formats.

- In the **Chinese IMF market**, Danone has managed to **hold ground against local players**, while other international competitors have lost share;
- Backed by a **strong online presence**, an increasing offering in **China Labels,** and **premiumization** of its leading brands.

- In the **Waters** segment, Danone and the other 2 main global players have seen share erosion in the last years, mainly to **smaller/regional players**;
- Share erosion has been greatest in Asian countries.

5. Disappointing Growth led to Disappointing Returns

2017-21 Annualized Total Shareholder Return (TSR) vs. Avg. LFL Growth (%)



Lower revenue growth explains part of Danone's poor share performance. Peers like Nestle are exposed to higher growth categories, like Pet Food and Coffee, contributing to organic sales growth

All of Danone's 2017 figures have been restated for IFRS 15

Source: Company and Peers' Publications, Euromonitor, BREQ's Estimates, IRI Worldwide, Bloomberg, Nielsen, JP Morgan Research, Goldman Sachs Global Investment Research

Operational Performance

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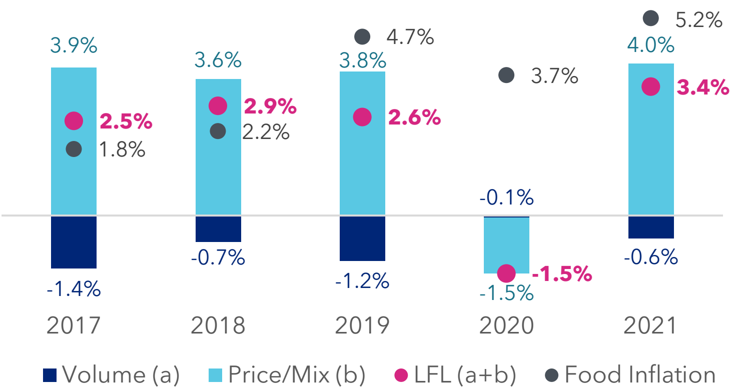
Danone's **limited pricing power** keeps it from passing on **rising input costs**, squeezing its margins

"Pricing power is one of the **key attributes of a quality compounder** (…) **Strong brands** are a well-known source of pricing power";
"In our view, a company has basic pricing power if it has the **ability to price to recover input cost inflation**."

Morgan Stanley

1. Since 2019 Danone is Showing Signs of Limited Pricing Power

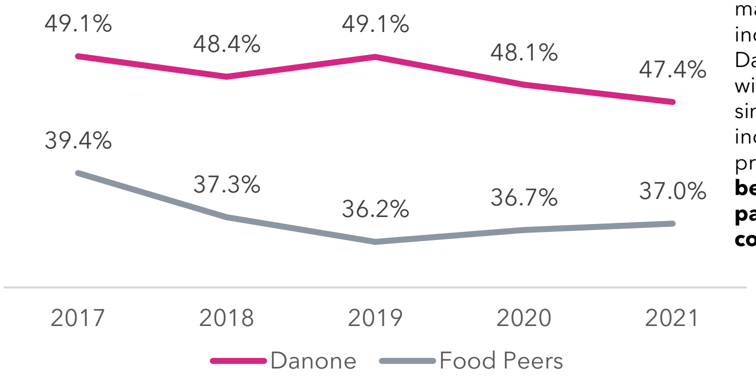
LFL Sales Change (%) and Estimated End Markets Food Inflation (%)



Since 2019, sales growth in Price/Mix has been below food inflation in end markets. This may be an indication of **limited pricing power, despite the brand's strength,** and a **limitation of passing on rising input costs**. When comparing inflation with LFL growth, which takes into account the impact of pricing decisions on sales volume, the conclusion is the same

2. Resulting in Gross Margin Erosion due to Rising Input Costs

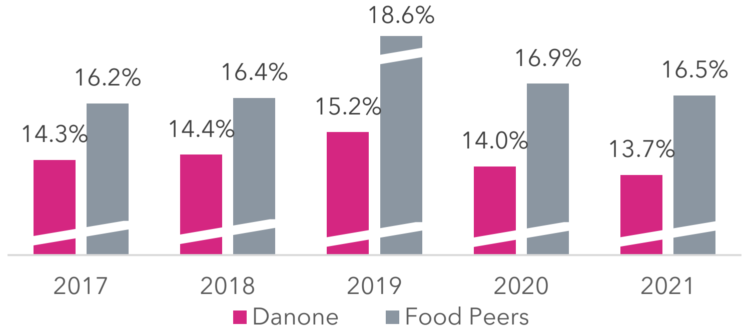
Gross Margin vs. Peers Median (%)



An analysis of gross margin against peers indicates that while Danone has been dealing with gross margin erosion since 2019, mostly due to increasing commodities prices, its **peers seem to be able to marginally pass on some of the costs to the consumer**

3. Pressured Operating Margins Despite Savings

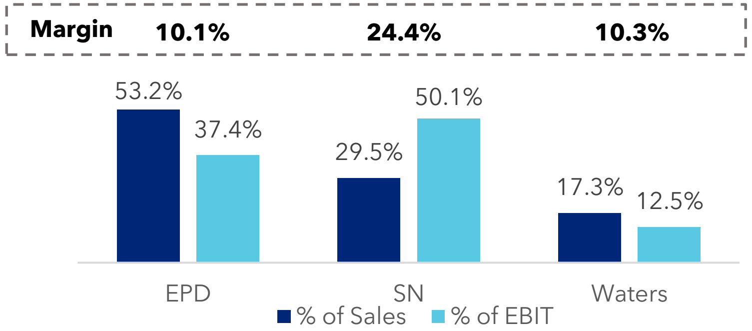
Recurring Operating Margin vs. Peers Median (%)



Initiatives to increase operational efficiencies and reduce spending, focused on COGS and SG&A, delivered an estimated recurring operating margin **gain of ~1,380 bps** between 2017-21, vs. inflation's estimated **impact of ~1,540 bps** (net loss of ~160 bps)

4. Segment Mix Partially Explains Margin Below Peers

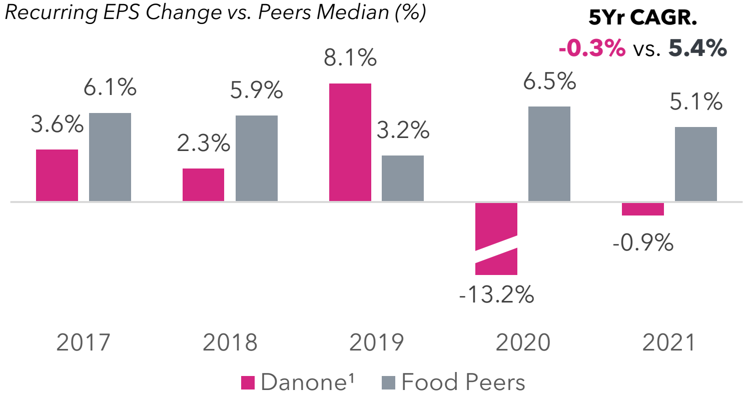
2017-21 Avg. Operating Margin (%) and Share of Sales and EBIT (%)



Segment mix also helps to explain margin below peers. **~70% of revenues come from segments with low margins** – EDP and Waters (~8.4% and 10.2% industry peers op. margins, respectively)

5. The Main EPS Detractor was Currency Depreciation

Recurring EPS Change vs. Peers Median (%)



Despite the effect of inflation on margins, the main detractor of Recurring EPS was currency depreciation, which also strongly impacted top line. **FX had an impact of approximately 17% of EPS decrease**, from 2017-21

All of Danone's 2017 figures have been restated for IFRS 15
Source: Company and Peers' Publications, Statista, OECD, FAOSTAT, Bloomberg, BREQ's Estimates,
1. Danone's 2017 EPS Growth was adjusted to exclude the effect of the Whitewave acquisiton

4 Capital Allocation

Underinvestment in Advertising & Promotion (A&P) and **insufficient portfolio rotation** are the main reasons behind poor top line growth and low pricing power

"Advertising & Promotions spend is the real 'CapEx' of Fast Moving Consumer Goods (FMCG), fuelling future growth and creating barriers to entry (…) Spending more on A&P correlates with **faster organic sales growth**."

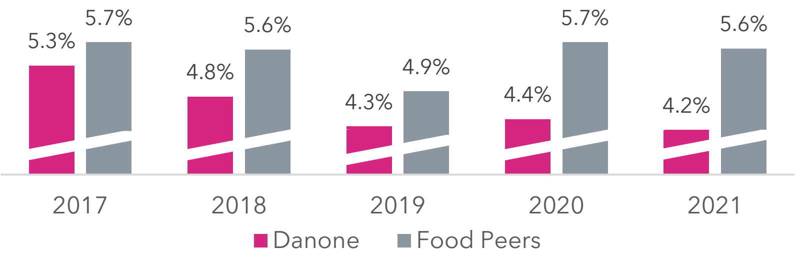
Morgan Stanley

"Consumer goods companies that are **frequent acquirers outperform their peers**, with twice the sales growth rate, 1.8 times profit growth, and 1.2 times total shareholder return (TSR) growth than the industry average"

BAIN & COMPANY

1. Underinvestment in A&P is Undermining Brand Value

A&P as a % of Net Sales (USA Only for Danone[1]) (%)

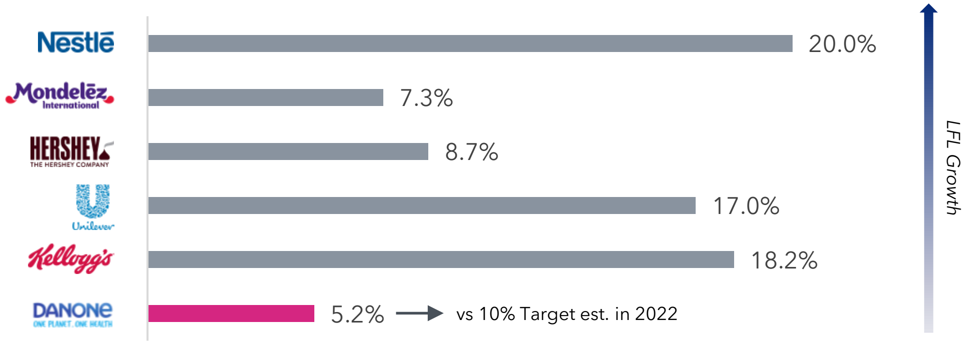


	As % of Net Sales (5 Yr Avg)		
	CapEx	R&D	A&P
Danone	**3,9%**	**1,4%**	4,6%
Peers	3,9%	1,1%	**5,5%**

Danone has reduced the level of investment in A&P (expense in the P&L), moving away from its peers and undermining brand value. This contributes to reduced sales growth, loss of market share and lower pricing power

2. The Lack of Portfolio Rotation Contributed to Stagnant Growth

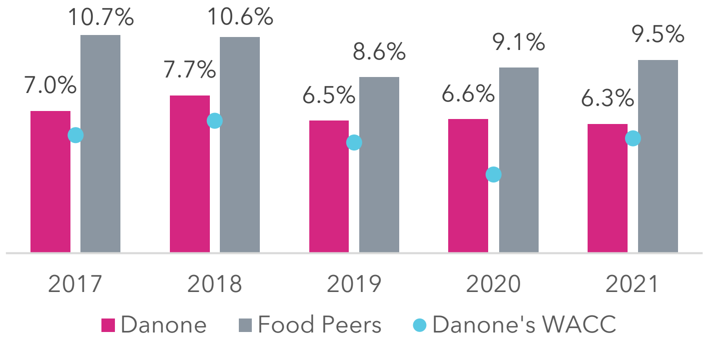
Estimated Portfolio Rotation Between 2017-21 (%)[2]



Danone has done very little in terms of pro-active portfolio management, "rotating" only ~5% of its portfolio between 2017-21 (ex-Whitewave). The lack of bolt-on acquisitions and strategic disposals contributed to stagnant growth, while players such as Nestle and Unilever used them to boost top line growth

3. Resulting in Minimal Value Creation

Danone's ROIC vs. Peers Median (%) and WACC (%)



Inappropriate capital allocation decisions contributed to return on capital barely covering the company's cost of capital, resulting in minimal value creation

Review of Capital Allocation Decisions

Acquired - U$12.5 bn in 2017

WhiteWave

Positives:

- Entry point to high-growth categories;
- Enabled Danone to benefit from changing consumer habits using the edge of an already established player;
- Doubled Danone's US business revenue.

Negatives:

- The US Milk Alternatives market was already decelerating at the time and presented lower growth compared to Europe;
- Relatively expensive acquisition (~21x EV/EBITDA) of a company that was facing market share erosion and execution issues;
- Management has set unrealistic expectations of revenue growth, with a €5 bn revenue target for 2025 (withdrawn), up from €1.7 bn in 2018.

Invested - ~€100 mm in 2020

Specialized Nutrition Business in China

Investment in a local Research Center and in IMF capabilities:

- Focus and commitment to one of its key markets;
- Dedicating required resources to sustain growth and continue to gain market share in its most profitable market.

Sold

Yakult

€1.8 bn in 2018-20

MENGNIU

€1.6 bn in 2021

Divestment of Strategic Partnerships

- **Minority stakes** in **non-core** EDP assets, with **limited operating synergies**;
- Proceeds were used to pay off part of the debt raised to acquire Whitewave (Yakult) and to fund buybacks (Mengniu).

Underperformer

Mizone Water

- Losing market share for 6 Years straight, due to strong competition from international players, such as Coke and Pepsi, as well as from local players like Nongfu Spring;
- According to Euromonitor and Company Publications, Mizone's market share went from 7.2% in 2014 to 3.4% in 2021;
- Lost its premium status to Chinese consumers;
- Distraction from other better-performing businesses;
- **Should be disinvested.**

Source: Morgan Stanley, Bain & Company, Company and Peers' Publications, Statista, BREQ's Estimates, Bloomberg

1. *Danone's 2020-21 figures were estimated based on management's statements*
2. *Equivalent to the estimated sales from acquired/divested companies as a % of Danone's Avg. Sales (17-21); Nestle and Unilever figures were disclosed by the management*

Corporate Governance

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Poor corporate governance and **misalignment of interests** between management and investors led to the mismanagement of Danone

"Leadership's priorities were misguided. (…) executive incentives put in place by the board are inadequate drivers of operational performance."

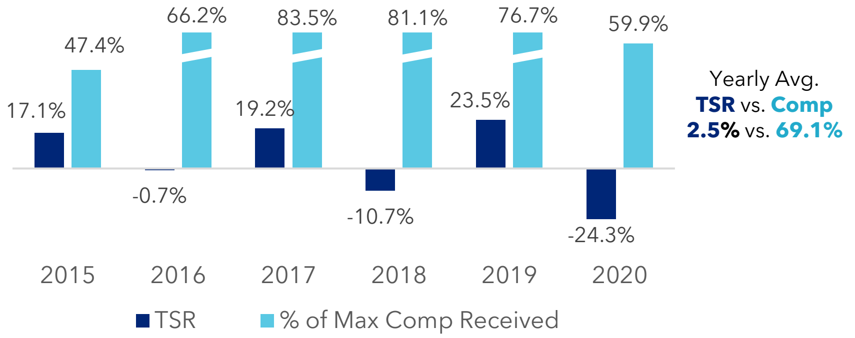
ARTISAN PARTNERS

Other investors have come out in favor of management changes:

BLUEBELL APICIL Causeway

1. Emmanuel Faber: Overpaid to Underdeliver

Total Shareholder Return (TSR) and % of Max Compensation Received (%)



Danone's compensation structure enabled Emmanuel Faber to receive an average of **69% of his maximum variable compensation** in the years he was CEO, while shareholders had an **average TSR of only 2.5%**

2. Compensation wasn't Based on Relevant Metrics

Weight of Performance Conditions in Share Compensation (%)

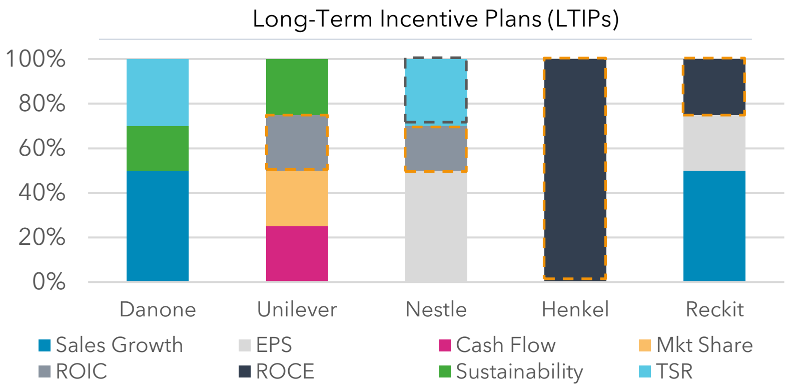
	Group Performance Shares (GPS) - Issue Year				
	2013-15	**2016**	**2017**	**2018-20**	**2021**
Sales Growth	67%	50%	50%	50%	50%
FCF	-	-	50%	30%	-
Environmental	-	-	-	20%	20%
Op. Margin	33%	50%	-	-	-
TSR	-	-	-	-	30%

GPS Granted to Faber

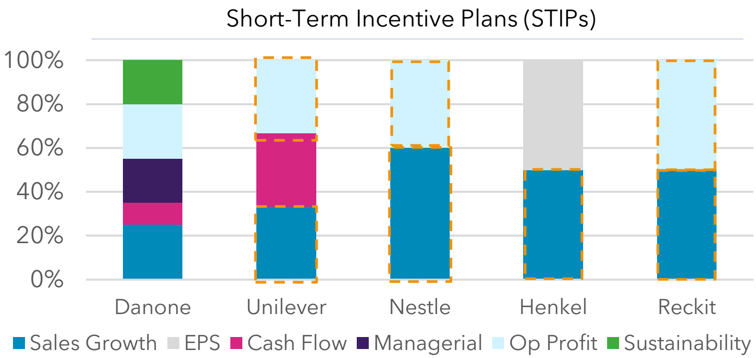
Most of Faber's variable compensation (granted between 2013-17) was dependent on the achievement of performance metrics that did not prioritize shareholder return nor the strategic allocation of capital. Total Shareholder Return (TSR) was only added as a condition to Group Performance Shares (GPS) in 2021.

3. The Compensation Structure Still Needs to Incorporate Return on Capital

Weight of Performance Conditions in Share Compensation (%)



The long-term compensation structure of key European Food & HPC peers highlights how return on capital (ROIC or ROCE) is a priority in other companies. Although also important, TSR is less frequent, used only at Nestle



Danone's short-term compensation is more in line with its peers. LFL sales growth and operating profit are prevalent among large European companies in the sector.

In Conclusion…

- Danone's weak organic sales growth can be attributed to two main causes:
  - High exposure to slowing markets and/or markets that were heavily impacted by the pandemic (External);
  - Growth below its end markets' growth, resulting in loss of market share (Internal);
- The company shows signs of limited pricing power, observed by the difficulty in passing on input price increases to customers. This has resulted in pressure on gross and operating margin;
- Danone's underperformance is directly linked to capital allocation decisions:
  - Reduction in brand investments (A&P expenses). This contributes directly to market share loss and pricing power decline;
  - The company doesn't proactively manage its portfolio, with low asset rotation, and prioritizes large and complex acquisitions (Whitewave);
- The previous management's decisions were not aligned with the company's best interests and that of its shareholders;
  - This was partly due to the inadequate incentive structure of the company's management

Source: Bloomberg, Company and Peers Documents