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TRANSCRIPT

Children in the Cocoa Fields

Featuring:

Cole Martin, *ESG Researcher, MSCI*

Mike Disabato:

What's up, everyone? And welcome to the week of the addition of ESG now, where we cover how the environment, our society, and corporate governance effects and are affected by our economy. I'm your host, Mike Disabato, and this week we have two stories for you. For the first one, I'm going to tell you a story about how a company decided to stay in Russia to sell its products and why it did that. And in the second story, we discuss how the cocoa market is changing for the better. Thanks, as always, for joining us. Stay tuned.

Mike Disabato:

Russia continues to advance into Ukraine, seemingly bombing indiscriminately as Ukrainian forces try to stall their advance. The invasion has created a complication for Western companies' corporate governance. Do they stay or do they leave? Many Western companies have already begun the exodus. McDonald's halted its operations in Russia, as has Starbucks, Apple and BP. And Unilever suspended exports and imports. Other companies though have decided to stay and in doing so, their boards made sure to make a statement on why. Pepsi, for example, suspended its sales of soda, but said it would continue its operations that manufacture milk, dairy products, and other necessary foods, partly as a humanitarian effort. Same as Nestle, who will continue to provide essential food products in Russia for similar reasons. As did Danone, a Paris based consumer foods company that said they feel they have a responsibility to the people they feed and the farmers that rely on them.

Mike Disabato:

These are all governance decisions. They were made by the board and we need to look into how the board is structured to understand why the decision was actually made. And Danone is an interesting case to do that because it is the first large public company to establish itself as an Entreprise à Mission or a purpose-driven company. It could do this because France passed the law in 2019 to modify its civil and commercial codes to allow companies to take greater consideration of social and environmental issues, and the legal status required Danone to not only generate profit for its shareholders, but to do so in a way that it says will benefit its customers health and the planet. And so to make this happen, Danone had to get the decision approved by a majority of its shareholders, which it did. 99% actually.

Mike Disabato:

And it needed to implement a mission committee that monitors whether Danone is following through on the goals it had to set up as a purpose-oriented company. And it also had to appoint a number of employee representatives to its board. There are currently two of them, one identifying as man, one as a woman, but really what it had done is it sought to broaden the idea of what a company could be, not just a source of profit maximization, rather a way to push a social impact ideal. Such an ideal caught the ire of activist investors in 2021, who came in and said there is an excessive focus on sustainability initiatives at the cost of shareholders, which caused the ousting of a very high profile CEO and chairman who has been ousted since 2021 and was replaced by CEO Antoine Bernard de Saint-Affrique, who seems to be keeping a number of Danone's mission-oriented plans in place.

Mike Disabato:

And we're seeing that now in how its communicating its decision to stay in Russia and how it's furthering the corporate structure and impact social plan through that decision. And this is why I wanted to highlight Danone at the start of our show today, because it is a unique look into how the structure of a company's governance will impact the community it operates in and its long-term presence in that community. Large companies wield a lot of power on our society so when their leaders decide to run a social program, its effects will be felt, which is a theme we're going to keep with in our next story that has to do with Nestle, coincidentally. But I think what we do on this podcast is we talk about the board in an abstract way. And in both these stories, this one and the one that follows, we get a better understanding of how that abstraction can be observed.

Mike Disabato:

Specialty crops like fruits and certain vegetables require a lot of labor to cultivate. Labor costs account for or around 40% of the total cost of raspberry, for example. Now compare that to corn. The labor costs account for around 5% of corn's total cost. And the difference in that price is automation. Tractors at the moment are basically million dollar autonomous vehicles at this point and corn is easily cultivated via a tractor. Whereas specialty crops require the gentle hand of man to pick, harvest, and package. So you might think, "Okay, handcrafted though, that means the price goes up, right? Artisanal products always get the bank." Well, herein lies the sadness around farming. Handcrafted doesn't equate to higher profits for your typical farmers. It just means more labor is needed to get your product to market. And in the agriculture sector, more labor typically means more labor abuses.

Mike Disabato:

It's an unfair system to say the least. And that isn't just my opinion. Academics from the Royal Tropical Institute, the University of Chicago, you don't want me to list them all, they use the academic equivalence of unfair in their field of research when talking about the agriculture system and specialty products. And there are few specialty products in a more unfair state than cocoa. The global cocoa and chocolate market size is around 45 billion USD. 50% of the world's cocoa is grown in the Ivory Coast, Ghana grows around 19%, and then there are smaller sections in Nigeria, Cameroon, Indonesia, Ecuador, Peru, and Brazil. But Western Africa is really where a majority of the bulk cocoa is grown because even those Latin American countries that I mentioned, they produce what's called fine or flavor chocolate, which is different and it's sold different. And the big candy bar companies, for example, buy bulk cocoa.

Mike Disabato:

And the challenges in growing cocoa are pretty extensive. There's deforestation that's a massive problem, bigger than in most specialty crops. Human rights abuses, impoverished workers, lack of transparency, and corruption and it has all the bad tones. So you might be thinking this all sounds extremely bleak and you're hitting me with two human rights abuses story in one day, but there's a change happening in the agriculture market, not just for cocoa, but globally.

Mike Disabato:

And this is due, again, to enhanced technology, specifically enhanced mapping technology, which we will get to, but I don't want to take away from the story. But just note that companies are getting better at tracking their supply chains. And when it comes to companies, Nestle is the largest by usage chocolate brand in the world. And it's attempting to pilot a newer version of an old system in 2022 to combat these challenges in its supply chain, because it wants to fix its supply chain. Cocoa's a big part of that. It has to fix cocoa. What it's going to do is Nestle's going to pay its farmers up to 500 extra Swiss Francs a year, that's around $540 US, if they can fulfill certain requirements set by Nestle. And when the business model of bulk cocoa is poverty, around 90% of all cocoa farmers are below the poverty line. So an extra $540 is a huge deal. Okay, so why does Nestle think that this program specifically is going to work? Well, here's my colleague, Cole Martin, to tell you why they think so.

Cole Martin:

What the payment and the broader policy are based on is a realization that the programs that have been created in the past to help alleviate farmer poverty, cocoa farmer poverty in West Africa simply haven't worked well enough. And the incidents of child labor, which various policies in the past have tried to fix, haven't worked. And in fact, even though there was a 2001 protocol passed by the US government, which included various NGOs and companies and governments in West Africa to reduce the prevalence of child labor in the cocoa industry, despite that happening, child labor over that time has actually increased. And this has been a black mark on the industry and it's ultimately led to lawsuits by former child laborers against very large chocolate companies, including Nestle, Mars, and Hershey.

Mike Disabato:

The lawsuit got all the way to the Supreme Court in the US where it accused Cargill, a major commodity trader that's actually privately owned, and Nestle of knowingly helping to perpetuate slavery at Ivory Coast cocoa farms. For technical reasons, the case was thrown out, but it was another wake up call for the major chocolate companies that they haven't done enough to combat the endemic of child labor in the cocoa supply chain, to which there's definitely an endemic at the moment. And it's been exacerbated by the COVID-19 pandemic, which closed schools all over the world. And these companies have really tried a number of programs. The World Cocoa Foundation estimates that cocoa and chocolate companies have invested at least 215 million US since 2001 in sustainability programs to fight child labor, such as boosting farmer income through increased productivity programs, rolling out what's called Child Labor Monitoring and Remediation Systems, or CLMRS, building schools and other programs.

Mike Disabato:

The big difference here, though, with Nestle's new program that was announced late January, 2022 is as long as the families can be traced, they can get up to 500 Swiss Francs, regardless of the farm's productivity. They just have to do four things. They have to provide school enrollment for all children in the household, ages six to 16. They have to implement good agriculture practices, such as pruning, which can increase crop productivity. They have to perform agroforestry activities to increase climate resilience, like planting shade trees, and they have to generate diversified income. For example, through growing other crops, raising livestocks, such as chickens, beekeeping, or processing other products like cassava. And Nestle has started off with about 10,000 families and hoping to get around 160,000 by 2030.

Mike Disabato:

So talking about Nestle as a company, they have multiple strong supply chain policies at the moment. These include identifying almost all tier 1 suppliers. Those are high risk suppliers. They have a robust labor code of conduct and they have supplier audits that include at least some tier 3 or raw material suppliers. That's good for the industry. So the question is why are they implementing another program right now? Was it just the lawsuit or was it something else?

Cole Martin:

I think there are a couple of other factors that may have prompted Nestle or may have affected their consideration a little bit. One is there are new regulatory laws that are coming into effect, which forced companies to pay a lot more attention to their supply chain and do a lot more due diligence on their supply chain. There are laws in France, in Holland, there's a variation of a due diligence law in Switzerland. The EU recently announced a new due diligence law for a company supply chain. And so there's much more regulatory pressure now on these companies than there would've been, let's say, five or 10 years ago.

Cole Martin:

There's a couple of other things I think that are helping to drive this. One is the technology is a lot better. Satellite mapping, for example, has improved tremendously in recent years. And what that's allowed to do is allowed companies to significantly improve the traceability of their supply chains. And so now we're seeing some of the major chocolate companies in the region, including Mondelez and Nestle and Mars, they're coming out and saying that they'll have full traceability of their cocoa supply chain by 2025. And these are all relatively new pronouncements and to some degree, that is being enabled by the improvements in geo-mapping and satellite technology, et cetera.

Mike Disabato:

By the way, at the moment Nestle only has 44% traceability of its supply chain to the cooperative. Mondelez is 63%. Mars has 51%. Hershey's actually reports a hundred percent traceability, but it buys its cocoa from a massive trader and processor called Barry Callebaut, which only has about 33% traceability to the co-op. Except for Hershey's, those numbers seem small, but there are even problems with those small numbers. Approximately half of the cocoa is still bought via indirect supply chains and the involved companies don't really know its origin. The second problem is the definition of traceability differs from company to company.

Mike Disabato:

Some companies just rely on standard setting organizations, but there others, like Nestle, that rely on technology and here is where the technology piece comes into play that Cole mentioned, and we can show its importance. In recent years, enhanced and proliferated satellites are making it easier for businesses to track their supply chains. They use satellite mapping, which gives companies a much deeper insight into how the cooperatives or farm groups are actually operating and being able to monitor your supply chain from afar for a company is important for the kinds of programs that they want to employ such as the one that Nestle is piloting.

Cole Martin:

And so it's a lot easier to do a specific program like this if you're able to find out and understand exactly who you need to be supporting with this type of program. And as part of that, there are also improvements in, for example, banking technology. So if this program were to have been created, let's say, 20 years ago, how would the money have actually been distributed to farmers that may have had to go to the governments of the countries? They may have had to go to the cooperatives. The transmission mechanism was a little bit more complicated, but now the companies can give the farmers money directly and that cuts out a lot of middlemen. It cuts out a potential for corruption, if that were to happen. And so it's easier for companies to do a program like this and they can do it in a much more targeted way.

Mike Disabato:

And here's why Nestle might assume it can spend at the high level, around a billion US in total, for this program in its entirety and not catch the ire of shareholders, new evidence that this program might actually work.

Cole Martin:

There's been a lot of research come out recently that has really shed a light on the problem. One of which is the Cocoa Barometer and another one is the NORC study from the University of Chicago, which detailed not only how prevalent child labor is in West Africa, but also they've showed empirical evidence or they've provided empirical evidence that when there are systematic well-targeted programs that are implemented effectively, the incidents of child labor in these places and on these farms does actually decline.

Mike Disabato:

That is the rosy picture of the situation. The intent may match the effectiveness, we have the technology to make it happen, regulation is starting to get behind these type of policies yet shareholders that have been good are pressuring Nestle to change and Nestle has been willing to change its practices. As I've known it before, buyer measurements, Nestle is a leader in the food industry. We rated it at AA on ESG factors and its shoulders above a lot of other companies out there. Still those shareholders cannot clap their hands in apparent success because the beginning of the program is when the work really starts for Nestle and other chocolate brands that may follow suit. And there are a number of institutional constraints that these companies will need to pay attention to if they hope to be successful in this important social impact program.

Cole Martin:

Giving money into farmer's hands could certainly help increase the wealth of farmers. And as we've seen in empirical studies, it may lead to an increase in the attendance rates of children in school. But I don't think that's the entire story. I think there are other factors that suggest that even if you put this amount of money into farmer's hands, it may not fully eliminate the problem of child labor on cocoa farms. And the reason why is because the nature of the cocoa industry itself. Cocoa farming is a very labor intensive process. It requires cutting pods off the trees, cutting the pods open with machetes, and then taking out the pulp and leaving it to dry in an open area. That requires labor and it's not apparent to me at this point that any part of that process is easily automated. Within the agriculture industry where we've seen massive of labor requirements, it's usually come in the context of improvements in harvesting technology. So things like tractors, for example.

Cole Martin:

In the case of cocoa, you don't necessarily have that. And so even in a situation where productivity increases, so for example, you have better farming techniques or better application of fertilizer, pods get bigger, or there are more of them per tree, that won't necessarily improve farm income because someone then has to harvest all of that. And in a situation where labor in West Africa is already relatively scarce, there are other industries in the region that are growing, the civil service, mining, and energy, it may not be that easy for farmers to replace the labor that they're losing by sending children to school. And one other note I'll mention on that is there are other institutional factors simply beyond the industry and the main one being that it is true that companies are helping to build schools in the region, but there are 1.6 million children in Ghana and Côte d'Ivoire right now who are engaging in some sort of farm labor activity.

Cole Martin:

Obviously not all of them are going to be working on the farm full-time and not in school at all. There's probably a range of school attendance within that group, but even if a small percentage of them are not in school at all, if you create a program where they're all sent to school, that requires a relatively large infrastructure investment for the schools. Not just for the schools, but teachers and potentially transport. These are rural areas and it may not be that easy to send pupils from one place to another. So ultimately, there are a lot of systemic challenges within the cocoa industry that may not necessarily be fixed immediately even if a program like Nestle is rolled out and rolled out relatively widely with other chocolate companies.

Mike Disabato:

And that's it for our show. I want to thank Cole Martin for joining me today to talk about the news with an ESG twist. And I wanted to thank you so much for listening. It really helps. If you like what you heard, don't forget to rate and review us. That will push us up higher on podcast list and more people can listen, which is great. And if you want to hear me every week, don't forget to subscribe on wherever you get your podcasts. That will help as well. Thanks again. And talk to you next week.

Speaker 3:

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