



REPORT

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2012

Palm Oil Investor Review: Investor Guidance on Palm Oil

The role of investors in supporting the
development of a sustainable palm oil industry



On the cover
Palm tree fruit, Malaysia

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Credits

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The World Wide Fund For Nature (WWF) is the world's leading environmental organization, with more than 1,300 projects operating in over 100 countries. WWF's vision is to build a future in which people live in harmony with nature.

The WWF Market Transformation Initiative seeks to shift markets of high impact food, fibre and biofuel commodities toward sustainable production through its more than 50 commodity experts working around the globe, extensive engagement with industry, and involvement with multiple industry roundtables. WWF's International Finance

Programme supports this strategy by leveraging our global intelligence to engage directly with investment banks, asset managers and other financial institutions. The team helps strengthen lending and investment criteria for key industry sectors, provides insights and data on environmental and social risk, fulfils critical research gaps, and helps unlock innovation breakthroughs in sustainable financial products.

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EXECUTIVE SUMMARY

The growth of the palm oil industry can be seen as a huge success. Production has risen from 10 million tonnes per year in 1990 to 50 million tonnes in 2011. This has helped lift millions of people in emerging market economies, particularly Indonesia and Malaysia, out of poverty.

However, the palm oil sector presents investors and investment analysts with material sustainability challenges such as deforestation, greenhouse gas (GHG) emissions and social conflicts with local communities.

Investors need to understand what these challenges are and what the implications are for long-term investments. As palm oil is one of a number of commodities that present sustainability issues for investors, lessons learned about sustainability in this sector can be applied to food, fibre and biofuel commodities more broadly.

The strong link between sustainability and investment success

Over the past decade, there has been growing recognition that sustainability is an important factor in investment success. This is driven by awareness that investing for the long term produces better results and that material environmental, social and governance (ESG) issues directly affect financial performance¹.

The role of investors is clear: they must emphasize that companies that integrate sustainability into their core strategy and operations are better able to mitigate risks and exploit opportunities, resulting in better investment performance. They must let investee companies know that if they ignore sustainability principles, they will find it harder to access capital in the future. **Understanding this is key to unlocking the power of billions of dollars of investment capital that can drive sustainability.**

This report

To assist investors in their role in promoting sustainable palm oil, WWF commissioned a review of 35 palm oil investors with significant exposure to the 68 largest listed entities in the palm oil sector. WWF surveyed these investors to learn more about their understanding of, and progress in dealing with, the challenges related to palm oil and sustainability. The report includes results of the survey, as well as company and market research.

Palm Oil Investor Review 2012:

- Identifies the investors most active in this sector;
- Examines the key challenges investors face in addressing ESG risks;
- Outlines the role that investors need to play to move the industry toward greater sustainability;
- Highlights how WWF can support this process.

Key findings from the survey

- Investors face internal organizational constraints in addressing ESG risks.
- Investors increasingly focus on ESG issues as more clients ask for ESG screens.
- Investors see the Roundtable on Sustainable Palm Oil (RSPO) as the most influential initiative and the de facto standard for investment screens, but want it to cover more issues and have “more teeth”.
- Investors continue to see significant challenges to investing in palm oil due to reputational risk, poor environmental performance and lack of company ESG disclosure.
- Investors believe the strengthening of the RSPO, demonstrable progress by its members toward certification and legislative changes that support the RSPO would have the greatest impact on increasing investment in sustainable palm oil.
- Investors need more disclosure, transparency and research so they can properly engage with their investee companies on sustainability issues.

Key recommendations

In light of the survey’s findings, the report makes several key recommendations.

FIRSTLY, INVESTORS NEED TO:

- Work within their organization to quantify their palm oil exposure, include palm oil in their ESG appraisals, commission and fund independent ESG research, and ensure that all fund managers have access to internal ESG analysts;
- Work collaboratively within the investment community to engage with and support the RSPO, highlight gaps in information and tools, drive sustainability reporting criteria and be more receptive to issues of sustainability;
- Work externally and publicly to incorporate ESG issues into ownership policies and actively engage with investee companies across the supply chain to join the RSPO and disclose commitments, pressure stock exchanges to mandate minimum reporting requirements for high impact sectors, and explore ways to develop demand for certified sustainable palm oil (CSPO) through market mechanisms.

THE RSPO SHOULD:

- Develop and publish uniform ESG performance data;
- Educate its financial members about the palm oil sector and the costs and benefits of certification;
- Help its members to develop and share best practice analytical and investment tools;
- Clarify its requirements for commitments and actions to transform the palm oil industry;
- Have flexibility in membership fees to encourage investors with minor assets in palm oil to join.

WWF recognizes that the financial sector is an important lever to drive sustainability in palm oil production and has developed several guides to assist investors.

WWF WILL CONTINUE TO ACTIVELY SUPPORT THE FINANCIAL SECTOR BY:

- Providing information and guidance to the wider investment community on material ESG risks in the palm oil sector through workshops and road shows, the sharing of existing WWF tools and guides and the development of new tools;
- Engaging with investors one-to-one and collectively;
- Providing frequent updates on relevant research and activities through the *Commodity Update Quarterly Newsletter*;
- Working with finance sector partners globally to ensure that they can incorporate the best ESG risk management tools in their transactions and to highlight opportunities to support sustainable palm oil businesses.

WWF believes that if investors, the RSPO and stakeholders such as WWF work together toward a common goal, the palm oil industry can expand in a sustainable way – making the industry more robust, boosting long-term investment returns and ensuring that emerging economies benefit from sustainable development.

We hope that the industry takes heed of this and that palm oil growers in particular, many of whom have already demonstrated significant success in embracing this philosophy, continue to embed sustainability across all their core operations and assist their scheme smallholders along this journey. Downstream users of palm oil are also impacted by palm-related ESG issues and should engage with investors to provide the necessary disclosure about commitments, timing and interim progress.

As for the role of the RSPO, we support the recommendations of this report and will seek to work, with support from our partners and stakeholder members, to raise awareness in the financial industry about sustainability matters. We will endeavour to use our platform to disseminate useful research and tools that will assist investors in assessing ESG issues. We are pressing ahead to strengthen the RSPO's ability to follow up on its members' commitments and facilitate greater and more consistent disclosure – to get "more teeth" as described by one investor. We hope that all our members will support this. We certainly welcome greater participation by investors in the RSPO and believe that they will make a valuable contribution to the RSPO's future development. In return, investors will be able to ensure their needs are taken into consideration, access best practices and use the RSPO as a tool to ensure greater sustainability in their investee companies.

Given the high yield of palm oil versus other edible oils, palm oil is an excellent crop to address the issues of feeding a growing population in a resource-limited planet. The RSPO recently launched the *2011 RSPO CSPO Growth Interpretation Narrative* which shows affirmative growth in the supply and sale of CSPO; significant movement of trends in the supply chain mechanisms; assertive membership growth in the RSPO from over 50 countries far and wide – all attesting to the commitment the world is starting to make toward sustainable palm oil. Still, we must continue to accelerate our expectations and contributions to transform the market.

It is my hope that investors will continue to take a greater leadership role in sustainable development and use their influence to change the behaviour of companies in which they invest. It will have to be an effort encouraged from all ends to make this work. When investors, civil society and the RSPO come together to work closely, we will be able to ensure that future expansion of palm oil continues to be fully committed to sustainable values.

FOREWORD

DARREL WEBBER
SECRETARY GENERAL,
ROUNDTABLE ON SUSTAINABLE PALM OIL

As a long-term advocate of sustainable agriculture, I am very pleased to welcome WWF's *Palm Oil Investor Review 2012*, a first-of-its-kind report focusing on the role of investors in promoting a sustainable palm oil industry.

It has become unquestionable that in the quest toward market transformation, all players directly or indirectly involved in a sector will converge in playing equally important roles in advocating and ensuring that the transition from conventional to sustainable practices is adopted. For sustainable palm oil, as this inaugural WWF review illustrates, the financial and investment fraternity have begun to acknowledge that a company's social and environmental policies correlate strongly with its financial performance. Sustainability clearly influences an organization's corporate governance – another key determinant of investment interest.

The review highlights the crucial role investors can play in developing a sustainable palm oil industry given their ability to influence their investee companies through engagement, and also to direct capital toward sustainable producers. The results of this review also provide a strong message to palm oil companies that sustainability is important to investors as it impacts long-term investment returns and that better ESG disclosure directly impacts the ability of investors to direct more capital into this industry.



1. PALM OIL: AN INTRODUCTION

Production of palm oil is increasing rapidly – and is often linked to unsustainable agricultural practices and environmental damage

Palm oil is the most common edible oil and is used in everyday foods, cosmetics and personal hygiene products. Global use of palm oil and palm kernel has increased almost fivefold since 1990, reaching 50 million tonnes in 2011. Its success is largely because palm oil offers the highest yield of any edible oil and therefore the most profit. Among the 17 oils and fats on the global market, palm oil has emerged as the leader, accounting for approximately a third of the world's edible oil production. Indonesia and Malaysia produce 85 per cent of all palm oil, with around 12.8 million hectares of mature plantations. Recently, there has been significant development of plantations in Africa, Latin America and other parts of Asia (driven in part by global demand and investment returns).

The food sector uses around 70 per cent of all palm oil. However, it is increasingly used in soaps, detergents, surfactants, cosmetics, pharmaceuticals and biofuel.

Palm oil is more productive than other oil crops and is important as an economic driver for some developing nations. However, its production is often linked to unsustainable agricultural practices. There is now a very real and growing concern that demand for palm oil has resulted in rapid and poorly managed expansion of production, causing serious deforestation and large-scale GHG emissions (from cutting down pre-existing forests to establish plantations and also – in Indonesia – from CO₂ emissions from peat exposed as plantations are developed).

Between 1990 and 2005 as much as 55-60 per cent of palm oil expansion was at the expense of natural forest². The forests destroyed and under threat are some of the most ecologically diverse in the world, with endangered species including the orangutan, tiger and Sumatran rhino. These forests also provide many “ecosystem services” such as water, food, fuel, fibre and medicinal products to local indigenous communities who are estimated to number around 50-70 million people in Indonesia alone³.

Further issues affecting the palm oil industry tend to be social, involving local livelihoods, workers' rights, health and safety, land tenure and access for local communities. A palm oil company's ability to gain a host community's approval will not only affect the project's success, but will also have a lasting impact on the company's reputation. There have been many community protests about companies' actions, including demonstrations over palm oil production in Malaysia as well as in Indonesia where recent incidents have occurred in Sumatra and Aceh.

If future expansion of palm oil production cannot be managed sustainably, growing negative ESG impacts will increase investor risk. The best way to mitigate these impacts is to ensure expansion happens according to international standards, such as those of the Roundtable on Sustainable Palm Oil. These require companies to demonstrate good practice in consultation, land management, biodiversity conservation, labour management and community engagement. Massive consumption in new markets like China and India, the rise of Indonesian domestic consumption (Indonesia is now the second largest global consumer), and new legislation on biofuels will further compound issues around palm oil.

The checks and balances that exist today are by no means perfect. Voluntary sustainability certification systems such as the RSPO are new (less than five years old, although the process of forming the RSPO scheme has been lengthy and has

included all stakeholders) and are still evolving in terms of governance, effectiveness and impact. There have been lapses in compliance and the credibility of all standards remains a “work in progress”. Nevertheless, CSPO is commanding an increasing market share. The RSPO is the dominant leader for palm oil certification, and RSPO-certified sustainable palm oil accounts for over 11 per cent of global crude palm oil production as of February 2012. Although many value chains trading in OECD markets have now committed to sourcing only RSPO-certified sustainable palm oil by 2015 (with attendant investment risks and opportunities relating to market access), the relative immaturity of the market has led to an imbalance between the upstream supply of CSPO from growers and the slow interim uptake from downstream users.

Boycotting or withdrawing from palm oil is not a solution. Given the high yield of palm oil versus other edible oils, sustainable palm oil production can provide significant benefits. Global demand is growing and the key concern is how palm oil is being developed. The entire sector must be transformed by engaging with investors to promote sustainability, so the industry expands sustainably into markets where sustainability does not carry the same profile as in Europe and the US. The industry needs support principally from market participants, from consumers to financiers and investors. Producers, traders and other actors in the industry need to commit to a range of ESG performance goals which investors should understand and request of investee companies.



The amount of palm oil expansion between 1990 and 2005 at the expense of natural forest



MAIN AREAS OF PALM OIL PRODUCTION

1. INDONESIA 2. MALAYSIA 3. AFRICA 4. LATIN AMERICA

2. PALM OIL: ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES FOR INVESTORS

ESG issues pose material threats to companies' operations, brand, reputation, profitability, stakeholders – and investment returns

Since the turn of the century, the investment and business community has focused more attention on ESG issues, largely driven by global concerns over climate change, population growth and pressures on food, fibre and fuel in a resource-constrained world. Investors are factoring ESG considerations into their strategies. The need to protect portfolios from increasingly real “ESG risks”, which can be damaging both to reputation and bottom line financials, drives this. It is also prompted by a growing recognition that

“ESG credentials” can be used to drive long-term value creation and asset protection. Companies that integrate sustainability into their core strategy and operations are better able to mitigate risks and exploit opportunities. The shift in emphasis from risk mitigation to investment opportunity will help integrate ESG considerations throughout the lifecycle of any investment.

The ESG issues that investors need to consider apply to different types of investments, including: direct investments in real productive assets (such as palm oil plantations); indirect investments in the equity of public companies that own productive assets or trade in the underlying commodity or derivatives; and investments in consumer goods, energy, animal feed, retailing and other companies which use and sell products containing palm oil. This creates an important dynamic in terms of how investors perceive and analyze the underlying risks associated with palm oil and the influence they have. Research for this study clearly suggests that the majority of global portfolios will be exposed to palm oil, given the pervasive nature of the commodity and globally interconnected supply chains. Table 1 opposite highlights some of the ESG risks investors may face and hence need to understand and monitor within their portfolios to optimize returns.

Given the major risks outlined in Table 1, shareholder value is likely to be eroded if growers do not implement sustainable practices that allow for strong monitoring and mitigation of negative ESG impacts. The downstream buyers and consumer-facing companies using palm oil are also exposed to risk due to consumer concerns about the impacts of palm oil. At the same time, it is increasingly likely that investors will themselves start to face reputational risks if they are seen to be investing in unsustainable palm oil.

Table 1 – Summary of the major ESG risks associated with palm oil operations

MAJOR RISKS	MITIGATING ACTIONS BY GROWERS
Environmental	
<ul style="list-style-type: none"> – Deforestation and use of fire for clearing leading to GHG emissions, haze and climate change; – Drainage of peat lands for planting resulting in CO₂ emissions and climate change; – Methane emissions associated with palm oil mill effluent treatment leading to further climate change. 	<ul style="list-style-type: none"> – Reporting on emissions; – Zero burning techniques; – Calculation of full lifecycle emissions; – Use of degraded lands and Better Management Practices (BMPs) to boost yields on existing plantations to minimize deforestation; – Strict avoidance of peat lands; – Transparency around new areas being developed and adoption of RSPO New Plantings Procedure; – Methane capture and use as fuel and/or aerobic composting of waste for soil conditioning.
<ul style="list-style-type: none"> – Biodiversity impact and species loss due to forest degradation and fragmentation from conversion to palm oil monoculture. 	<ul style="list-style-type: none"> – Use and disclosure of Environmental Impact Assessments for site selection; – Strict avoidance of conversion of High Conservation Value forests and natural forests; – Policies on preservation of biological diversity through biodiversity offsets and mitigation banking; – Disclosure of impact on endangered species.
<ul style="list-style-type: none"> – Soil degradation related to intensive production, monocultures; – Planting on unsuitable slopes causing soil erosion. 	<ul style="list-style-type: none"> – Implementation of BMPs to maintain soil fertility (nutrient recycling, for example) and minimize erosion and degradation of soils; – Use of maximum permissible slope standards.
<ul style="list-style-type: none"> – Excessive water use; – Lack of riparian buffers resulting in contamination of rivers and soil erosion; poor management of palm oil mill effluent severely impacting aquatic biodiversity. 	<ul style="list-style-type: none"> – Implementation of water management plans protecting wetlands and riparian buffer zones; – Close monitoring and treatment of effluents and optimization of water use.
<ul style="list-style-type: none"> – Pollution and waste/toxicity; agriculture chemicals emissions; – Excessive use of pesticides and fertilizers. 	<ul style="list-style-type: none"> – Strict waste disposal and treatment procedures in place; – Recycling options and use of renewable energy (for example, biogas plants using waste products); – Policy on use of harmful fertilizers and pesticides and appropriate storage facilities for all chemicals; – Integrated Pest Management and use of nutrient recycling to reduce fertilizer application.

MAJOR RISKS	MITIGATING ACTIONS BY GROWERS
Social	
– Displacement of communities/indigenous people due to loss of land use rights and conflicts with imported labour.	<ul style="list-style-type: none"> – Documented Free, Prior and Informed Consent; processes for dealings with local communities; – No legitimate contest of land titles by local communities; – Active stakeholder engagement in practice; conflict resolution procedures in place.
– Poor and unsafe labour conditions for workers.	<ul style="list-style-type: none"> – Occupational health and safety protocols in place; – Provision of worker training schemes and use of personal protective equipment.
– Human/labour rights abuses such as lack of political rights and access to education for children.	<ul style="list-style-type: none"> – Implementation of International Labour Organization core labour standards (no child or forced labour, no discrimination, freedom of association).
– Public backlash due to lack of disclosure of impact on communities.	<ul style="list-style-type: none"> – Disclosure of plans and commitments to fair dealings with indigenous people; – Offers of employment opportunities to local inhabitants.
– Unfair treatment and price setting when buying from smallholder producers.	<ul style="list-style-type: none"> – Transparent and fair contracts with independent suppliers; – Investments in extension services to increase smallholder yields.
– Negative feedback or protests from NGOs.	<ul style="list-style-type: none"> – Active engagement of NGOs as part of stakeholder engagement; reporting on progress to NGOs.
Governance	
– Lack of disclosure on ESG matters.	<ul style="list-style-type: none"> – ESG auditing and reporting; – Reporting against commitments; – Disclosure on certification process.
– Payment of bribes and illegal fees due to corruption.	<ul style="list-style-type: none"> – Disclosure of fines and fees paid (basis, counterparty).
– Ownership disputes and illegal operations.	<ul style="list-style-type: none"> – Mapping and disclosure of concession areas and land banks; – All legal permits in place.
– Destruction of natural capital base on which company depends.	<ul style="list-style-type: none"> – Use of accounting practice FRS41 to account for change in valuation of biological assets.

Table 2 demonstrates how risks caused by unsustainable production can impede the commercial value drivers of a palm oil business and result in significant reductions in shareholder value and investment returns. WWF's recent study on *Profitability and Sustainability in Palm Oil Production* also analyzes the relationship between sustainability and value drivers. It shows that the incremental financial benefits of implementing the RSPO's Principles and Criteria for sustainable palm oil production outweigh the costs – providing a strong business case for sustainability.

The business model of the palm oil industry has to evolve toward greater sustainability. It should focus on improving yields and using existing degraded lands rather than converting forests. This will maximize growth and returns while minimizing environmental damage and financial risk to investors.

Table 2 – Examples of risks and impact on shareholder value

RISKS	HOW RISKS CAUSED BY UNSUSTAINABLE PRODUCTION CAN ERODE SHAREHOLDER VALUE
Compliance risks	<ul style="list-style-type: none"> – Violation of regulations leading to fines and/or suspension of plantation manager's/owner's concession, operating licences or land lease.
Social risks	<ul style="list-style-type: none"> – Conflicts with local communities and labourers leading to industrial stoppages and operating losses; – Pressure from NGOs leading to loss of social licence to operate.
Market risks (product markets and financial markets)	<ul style="list-style-type: none"> – Loss of market as demand for sustainable palm oil grows; – Reduction in access to capital as lenders reluctant to finance operations and credit risks increase; – Fewer trading partners, reduced international opportunities; – Import/export embargo imposed against country can result in collapse in market access; – Divestment by risk capital investors – pressure on share prices.
Reputational risks	<ul style="list-style-type: none"> – Unsustainable practices damaging reputations; – Indirect reputational risks to trading partners; – Consumer backlash leading to boycotts and reduced sales; – Increased media pressure, both locally and internationally, can erode brand value.
Productivity risks	<ul style="list-style-type: none"> – Soil erosion, water contamination and failure to maintain site fertility will reduce future yields and returns; – Planting on peat lands is a high cost and low yielding practice that will impact margins; – Failure to maintain biodiversity will eliminate natural pest control animals and increase costs and pollution risks from use of pesticides; – Loss of natural habitat in and around plantations leads to localized climate differences, in particular a drier microclimate, which further reduce palm oil yields; – Suboptimal timing for planting of nursery palms (often planted at three years of age, which is too old) leads to lower productivity in the early years.

If palm oil production continues to cause unfettered clearing of forests, destruction of biodiversity and carbon emissions, the industry is likely to seal its own fate. The natural capital that sustains it will be depleted.

Adopting sustainability measures may have short-term implementation costs and may not lead to significant price premiums. However, there will be upsides to investment returns via stronger operational controls, BMPs, targeted and reduced use of inputs and significantly increased yields, especially from smallholders, on whom large plantations depend to supply their mills to achieve full utilization. For example, closing the gap between the current average smallholder yield of 4 tonnes per hectare and the “best-in-class” yield of 8-9 tonnes per hectare highlighted by the Malaysian Palm Oil Association will result in a substantial boost to palm oil output. Smallholders typically buy poor seeds from non-certified sources and access to good planting materials as part of BMPs is key to boosting yields. Better community engagement will also lead to major savings by avoiding conflict and production stoppages.

It is not just the environment and society that stand to gain from sustainable palm oil practices. Adopting these practices can increase palm oil companies’ access to global markets, provide commercial opportunities and enhance brand reputation. Joining the RSPO can enhance palm oil growers’ access to large US and European buyers, who are increasingly moving toward sustainable proprietary supply chains to have control and certainty over source materials. Gaining trust from markets and governments can also mean local or international expansion opportunities for growers as a preferred supplier.

RSPO-certified plantation companies train staff to perform checks on palm fruit to ensure it meets RSPO regulations. All palm fruit is weighed and records are kept.



THE VALUE DRIVERS OF PALM OIL

RISK MANAGEMENT, REVENUE GROWTH (THROUGH YIELD IMPROVEMENT), COST SAVINGS THROUGH OPERATING EFFICIENCY, TECHNOLOGY, LICENCE TO OPERATE, BRAND ENHANCEMENT, MARKET ACCESS, CAPITAL ACCESS

3. SUPPORT FOR MORE SUSTAINABLE PRODUCTION AND TRADE

Industry and the finance sector are taking action to promote the development of a sustainable palm oil industry

Developing and implementing a responsible approach to palm oil lending and investing is often part of a financial institution or investor’s broader efforts to adopt sustainability across all its operations. Investors with broader ESG policies should make sure they adequately address high risk sectors like palm oil with sector specific measures. For an investor, viewing ESG

matters as integrated and central to a fund’s core business is becoming as essential as looking at the fund’s financial sustainability.

Equally for industry, the lack of a strong public policy/regulatory environment on sustainability has led to several voluntary sustainability initiatives to fill the policy vacuum. The growth of multi-stakeholder initiatives such as the RSPO presents new opportunities for the industry to catalyze sustainable development. The ability of these initiatives to deliver on this promise depends fundamentally on better and shared information on the impacts, failures, successes, obstacles and opportunities associated with their implementation. It also depends on all stakeholders supporting a common vision. Investors play a crucial role in informing and shaping the industry, given their ability to influence investee companies through voting rights and active engagement and also to direct their investment capital toward sustainable producers.

The recent financial crisis exposed the risks facing all investors and highlighted the significance of accountability, transparency and the consideration of “extra-financial” research in investment processes. Addressing ESG risks and opportunities is being mandated into asset owners’ duties – failure to do so is increasingly being seen as a breach of fiduciary duty⁴. In response to this, both buy- and sell-side analysts are increasingly paying attention to ESG issues. Communication between investors and companies on ESG issues has not been very sophisticated, but analysts are steadily improving the quality of their research and models. There are projects under way (see Table 3 below) to map ESG issues against financial value drivers and better tailor

Table 3 – Examples of initiatives mapping ESG performance to financial value drivers

EXAMPLES OF INITIATIVES TO MAP ESG PERFORMANCE
The United Nations Principles for Responsible Investment Initiative (UN-PRI) has looked extensively at agribusiness and the role responsible investors can play around commodities (see <i>onValues, Responsible Investment in Commodities</i> , 2011 and Farmland Working Group, <i>Principles for Responsible Investment in Farmland</i> , launched in September 2011).
The Prince of Wales’s Accounting for Sustainability Project is developing practical tools to better connect environmental and social performance to strategy and financial performance.
CSR Europe has a programme valuing non-financial performance (European Framework for Company and Investor Dialogue).
Over a number of years, the United Nations Global Compact has looked extensively at the communication of ESG value drivers at the company-investor interface (see <i>Who Cares Wins: Connecting Financial Markets to a Changing World Initiative</i>).

company communications to investor needs. For the palm oil sector, however, this process is lagging and should be seen as an opportunity for investors.

While there has been discernible improvement in the way companies conceptually link ESG issues to their core business, they have not quantified the impact of these particularly well.

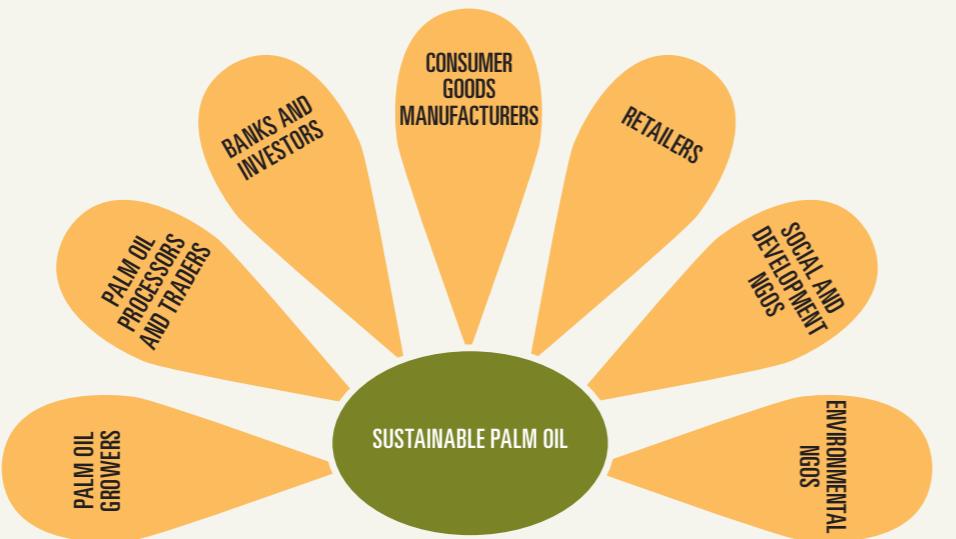
Below we highlight the key initiatives supporting the development of a sustainable palm oil industry:

The **Roundtable on Sustainable Palm Oil (RSPO)** is a multi-stakeholder association of over 500 members representing roughly half of total palm oil production. Formed in 2004 with the intention of achieving a balance of people, planet and profit within the palm oil industry, the RSPO has developed the most credible mainstream standard available for sustainable palm oil production, covering key environmental and social criteria. Its objective is to promote growth and use of sustainable palm oil products through credible global standards and engagement of stakeholders. The RSPO's challenge is to successfully bring together and build consensus among a broad range of stakeholders along the whole palm oil supply chain. Members are divided into seven stakeholder categories, as shown in Figure 1. Financial institutions that are members of the RSPO include ANZ, BNP Paribas, Citigroup, Credit Suisse, Generation Investment Management, HSBC, IFC, Rabobank, Standard Chartered and WestLB.

The current estimated production capacity of RSPO-certified production units is about 11 per cent of global production or about 5.5 million tonnes of CSPO annually. Approximately 46 per cent of this comes from Malaysia, 42 per cent from Indonesia, 9 per cent from Papua New Guinea and the Solomon Islands, 3 per cent from Brazil and less than 1 per cent from Colombia. CSPO is expanding globally, with countries including Thailand, Cambodia, Ivory Coast, Ghana and Gabon developing RSPO standards. In June 2011, the RSPO made its trademark available for members to use in the market.

WWF's **Palm Oil Scorecard 2011**, now in its second edition, analyzes companies' commitment to sourcing sustainable palm oil as a key driver to push the market forward. The RSPO is calling on companies buying palm oil to publicly commit to sourcing 100 per cent CSPO by 2015. It hopes this will address downstream buyers'

Figure 1 – The seven stakeholder categories within the RSPO



SOURCE: RSPO

slow CSPO uptake. By publishing a scorecard assessing the palm oil buying practices of 132 retailers and manufacturers from Europe, Australia and Japan, WWF is putting the spotlight on the leaders and laggards, demonstrating best practice and compelling the industry to greater uptake of CSPO.

WWF's **Profitability and Sustainability in Palm Oil Production** study is a recently published paper examining the incremental financial costs and benefits palm oil production companies incur as a result of implementing the RSPO's Principles and Criteria. The report's objective is to produce a clear guide to help companies and financiers make decisions and plans around RSPO certification.

WWF's **Palm Oil Financing Handbook** was developed in 2008 to support financial institutions wanting to develop and implement a responsible palm oil financing and investment policy, based on RSPO standards. It gives institutions a comprehensive overview of the main issues surrounding responsible palm oil financing. The handbook also includes materials tailored to specific areas of work within a financial institution, for example, policy management, credit and investment analysis.

The **Sustainable Palm Oil Investor Working Group (IWG)** is a rapidly growing group of investment organizations representing assets under management of over US\$1.4 trillion⁵. All are members of the UN-PRI and support the development of a sustainable palm oil industry through the RSPO. IWG aims to attract more investor interest and provide a coherent and unified investor perspective to support the palm oil industry's development. IWG also aims to engage directly with investee companies across the palm oil value chain to encourage the production and purchase of sustainable palm oil.

More broadly, the UN-PRI provides a framework for considering ESG issues which can affect the performance of investment portfolios. The IWG convenes under the UN-PRI Clearinghouse, a forum for investors to work together on certain issues. The Clearinghouse is becoming a potent channel for collaboration. Investors can use it to create a unified message in a relatively informal setting.

The **International Finance Corporation (IFC)'s Performance Standards**, specifically PS6 which states the IFC's position on biodiversity conservation and sustainable management of natural resources. It ties the financing of soft commodities with credible voluntary standards, such as the RSPO. It is therefore an integral part of any discussions investors might have with companies as well as disclosure related to sustainability reporting.

IFC's **Biodiversity and Agricultural Commodities Program (BACP)** is designed to address the threats posed by expansion in agricultural commodities through market transformation strategies for target commodities, initially palm oil and soybeans. The BACP provides the opportunity for partnerships among industry, public sector and civil society stakeholders to bring about significant progress in biodiversity conservation. There are currently four approved BACP projects in the palm oil sector: three projects test and refine practices and one directly supports the RSPO to provide relevant tools and information for grower members so they can better implement the Principles and Criteria related to biodiversity.

The **Forest Footprint Disclosure Project** helps investors identify the valuation risk caused by the forest footprint of their portfolios and supports companies to identify and manage the forest footprints in their supply chains. Their focus is on disclosure, with information requested from some 300 companies globally. The initiative aims to enhance transparency for the investor community by ensuring that companies using palm oil, biofuels, soy and beef can identify and manage deforestation risks.

In 2011 the **Global Reporting Initiative** released supplementary guidelines for all companies in the food processing sector. These highlight the demand for comprehensive data and disclosure in areas such as sourcing, product information, environmental and social impacts and labour practices.

In January 2011, the **Sustainable Stock Exchanges Collaboration** reported on exchange listing requirements. Global exchanges are gradually releasing guidelines on sustainability reporting. To date, stock exchanges have adopted a patchwork of sustainability approaches, including sustainability indices and specialized products which can encourage greater ESG disclosure. However, few exchanges have listing rules in place beyond governance, suggesting that there is room for embedding ESG factors into initial public offerings and ongoing listing requirements. The Sustainable Stock Exchanges Collaboration has called on the listing authorities of the global stock markets to consider possible actions exchanges can take, including improving company disclosure of ESG factors.

The **Banking Environment Initiative (BEI)** was set up in 2010 to identify ways for banks to collectively redirect capital from environmentally damaging activities toward sustainable, low carbon growth. The Cambridge Programme for Sustainability Leadership hosts the BEI's secretariat with support from the Prince of Wales's International Sustainability Unit.

The BEI works closely with the **Consumer Goods Forum**, a network of 650 global corporate members trying to achieve zero net deforestation in their supply chains by 2020. The forum brings together CEOs and senior management of retailers, manufacturers and service providers from 70 countries.



A Papua New Guinean worker harvests a ripe palm fruit to ready for the mill.

4. ABOUT PALM OIL INVESTORS

Our survey reveals who invests in palm oil, what issues they face and what they want to know

In late 2010, WWF commissioned a palm oil investor survey to achieve four key objectives:

- Identify investors active in the sector;
- Understand the key challenges these investors face in addressing ESG risks;
- Outline the role that investors and the wider financial industry need to play to move the industry toward greater sustainability;
- Highlight how WWF can help by sharing applied research, tools and information with financial institutions.

We undertook the survey on the basis that we would disclose no information about the performance of individual institutions/funds, but would aggregate results to inform this report.

We created a database of 68 listed entities, including 54 primary listed palm oil companies with the largest palm oil land banks, and 14 secondary listed holding companies, which were often the most significant shareholders of primary listed palm oil companies. We contacted over 85 investors (fund managers), including the top 50 most exposed to palm oil production. We chose these investors based on a quantitative analysis of cross-holdings of the 68 listed equities.

We managed to engage with over 50 of these investors (and often with more than one individual within a firm). Thirty-five investors, including both investment managers and asset owners (trustees, fund administrators) provided written responses to the survey. A few investors were reluctant to openly discuss their investment approaches, principally because they lacked awareness of WWF's supportive and non-confrontational work to promote sustainable production of commodities and responsible investing. It was surprisingly difficult to get all investors to respond to the survey. About two-thirds of the investors who responded were principally involved in ESG or governance functions, rather than general portfolio management. Several US- and Asia-based investors had firm-wide policies not to engage in industry surveys, and a number of US hedge funds which held investments had since divested their holdings.

We asked 38 in-depth questions about investors' approaches to screening, the RSPO and the challenges and opportunities they faced when investing in the palm oil sector. While the shareholding data (correct as of June 2011) may no longer be current, the issues raised and key findings are still relevant and provide useful insights into how the financial industry can influence and increase the sustainability of the palm oil industry.

The sections below summarize the findings from our survey.

i. A reminder of who invests in palm oil growers

Our selection of 68 companies with plantation interests represents US\$152 billion in total market capitalization. It includes 54 companies with direct palm oil plantation interests (US\$98 billion) and 14 holding companies (US\$54 billion) with sizeable interests in these companies. Private insider interests, typically family/founder holdings, account for over half (52 per cent or US\$79 billion) of the total invested.

Institutional investors hold under a quarter (23 per cent or US\$35 billion) of the total equity and the public/retail float accounts for the remaining 25 per cent. Of the US\$35 billion institutional interest, investors in Asia hold US\$23 billion (65 per cent), with the remainder held in Europe (24 per cent) and North America (11 per cent).

While investors manage billions of dollars of clients' money, typically only a fraction of a per cent is invested in palm oil production, through investments in palm oil growers or companies/conglomerates with plantation interests. As shown in Table 4 below, only a handful of global investors have a sizeable percentage of their portfolios invested in palm oil companies. For many investors, palm oil still represents a very small proportion of their total assets under management. This varies at parent, firm and fund level.

Figure 2 – Split of shareholdings by type

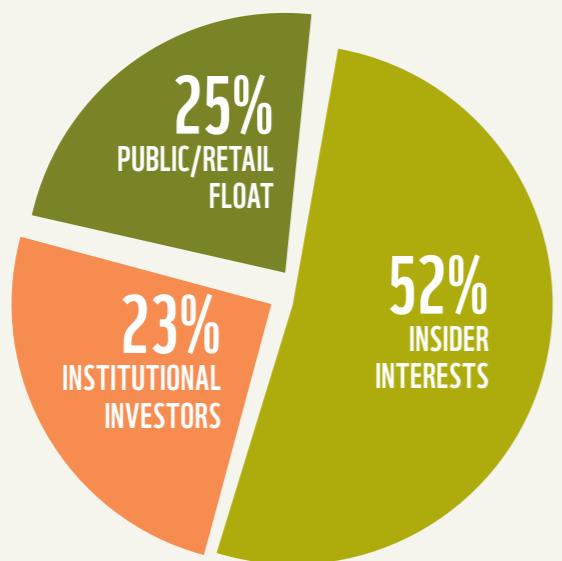


Figure 3 – Exchange share of market capitalization



Table 4 – Investor exposure to palm oil as a percentage of assets under management

PALM OIL INVESTMENTS AS PERCENTAGE OF TOTAL EQUITY ASSETS UNDER MANAGEMENT (AUM)			
Palm oil % of AUM	No. investors (parent firm)	Total AUM (US\$)	Total invested in palm oil companies (US\$)
>10%	17	96bn	23bn
1-10%	70	626bn	7bn
<1%	220	22.1tn	53bn
Total	307	22.8tn	82bn

SOURCE: ENVIROMARKET RESEARCH (BASED ON AVAILABLE AUM DATA)

The market is concentrated in only a small number of asset owners. We estimated that 20 managers control over 80 per cent of funds invested in the sector.

Most of the growers/plantation companies are listed in Asia, with the Malaysian, Singaporean and Indonesian exchanges accounting for 90 per cent of the total market capitalization (see Figure 3 above). The bias toward Asian bourses has implications for investors:

- European and North American investors are geographically remote from the companies they are covering; access to management is limited and cultural and language barriers accentuated.
- Western investors' limited access to management of palm oil companies highlights the need for better collaboration both within global firms and between investors themselves.
- Index funds that track either regional or country exchanges within South East Asia will feature a higher exposure to palm oil.
- Listing requirements in Asian bourses are typically more relaxed compared with their European or North American counterparts, making third party certification all the more important given this remoteness.

Stock exchanges play a key role in fostering market confidence and promoting good governance and disclosure. Some exchanges have started to play a role in promoting better ESG disclosure through listing requirements, driven by reputation protection and increasing competition⁶. They are in a strong position to promote improved ESG practices and reporting among the companies on their exchanges, either by introducing sustainable investment indices or listing requirements mandating sustainability reporting. Raising the bar on reporting will reduce the weighting of unsustainable businesses and reduce financial shocks to investors caused by ESG issues. For exchanges, the race is not to the bottom but to the top in terms of quality of listings.

Several exchanges, many of them in emerging markets, have introduced initiatives designed to raise issuing companies' awareness of or to promote and/or require better transparency and disclosure on ESG-related risks and performance issues:

- **Singapore:** Most recently, the Singapore Stock Exchange released voluntary guidelines on sustainability reporting to encourage companies to improve disclosure of their environmental and social impact. The stock exchange has also issued a policy statement outlining principles such as the responsibility of company boards for sustainability and the importance of ESG issues for the long-term performance of companies.

- **Malaysia:** Bursa Malaysia launched its own Corporate Social Responsibility framework and has further tightened listing requirements to raise corporate governance standards.

- **Indonesia:** The stock exchange launched the SRI-KEHATI index in 2009 with the Indonesian Biodiversity Foundation. It tracks the performance of Indonesian companies with sound sustainability practices and acts as a benchmark for best practice for investors and companies.

- **London Stock Exchange (FTSE):** The FTSE's Environmental Market Classification System and Indices provide one of the world's most comprehensive global classification systems for environmental markets.

“To date, we have not felt comfortable investing in any palm oil producers as we feel that the significant social and environmental issues surrounding the industry have not been adequately addressed.”



ii. Investor survey: summary of key findings

(1) BACKGROUND AND OVERALL VIEW ON SECTOR

The palm oil sector presents an attractive growth proposition for investors but ESG issues still cloud the ability of many to invest. There is strong demand from investors for sustainably managed plantations demonstrating a strong handle on ESG issues. For example, a number of Socially Responsible Investment (SRI) funds have included New Britain Palm Oil based on its environmental and social credentials.

Investors generally have a good understanding of the environmental issues involved in palm oil production and have started to include these issues in their investment management and active ownership programmes (proxy voting and shareholder engagement). Responsible investment is gaining recognition as a way to manage investment risk, with engagement policies covering areas such as environmental impact, labour rights and avoidance of bribery and corruption. Eighty-seven per cent of investors questioned said they either agreed or strongly agreed that environmental impacts from palm oil production may pose a material risk to investments.

(2) INTERNAL ORGANIZATIONAL CONSTRAINTS IN MANAGING PALM OIL EXPOSURE AND ESG RISKS

Investors do not currently track or quantify their exposure to palm oil. Worryingly, while investors overwhelmingly agree that the environmental risks of investing in palm oil are high, they do not identify or quantify these risks across their portfolios. Very few investors knew or had access to details of their palm oil holdings; they rarely look at their exposure to the commodity on aggregate and do not explicitly monitor their exposure “given the complex nature of the industry”.

This is a reflection of the way the industry is externally appraised, with performance typically measured at the individual fund level. Investors rarely screen their portfolio at a firm, regional or global level for exposure to specific stocks or underlying commodities. Typically, we found it was investors holding more than a few per cent in palm oil growers who knew the extent of their holdings.

Overall, investors are aware of the issues from an individual perspective but find it difficult – especially in mainstream investment houses – to influence investment decisions beyond their immediate regional or fund mandates. ESG analysts often informed only the SRI funds rather than their Asian fund management holdings and there was very rarely a centralized ESG function accessible to fund managers globally within a firm. Only a few investors had a centralized risk function able to coordinate these efforts.

Investors often do not have the internal capacity to assess complex ESG issues presented by the palm oil sector. Asset managers and owners often have small to medium sized teams, under-resourced to deal with increasingly complex ESG issues. Fewer than 10 staff may run a fund with US\$4 billion assets under management.

“We would need to undertake an extensive global review of all our portfolios and their holdings to determine their exposure to the palm oil industry.”



*Harvesting palm fruit.
Palm fruit is still harvested
entirely by hand.*

© JAMES MORGAN / WWF INTERNATIONAL

(3) INVESTORS' APPROACHES TO AND GROWING FOCUS ON ESG

Asian, European and US investors' approaches to screening for palm oil issues vary markedly. Europe still leads the way in making ESG screening the norm. In Asia, while governance issues are seen as important, investors are far less likely to address environmental and social risks associated with palm oil in their investments. Asia-based/-focused investors typically do not have an ESG analyst, a reflection of there being only US\$60 billion⁷ currently invested in equity SRI funds in Asia. Global SRI funds are estimated to hold around US\$9.9 trillion as of September 2010⁸. While there is little pressure for change, industry analysts we spoke to in Asia were keen to learn more about environmental issues related to palm oil.

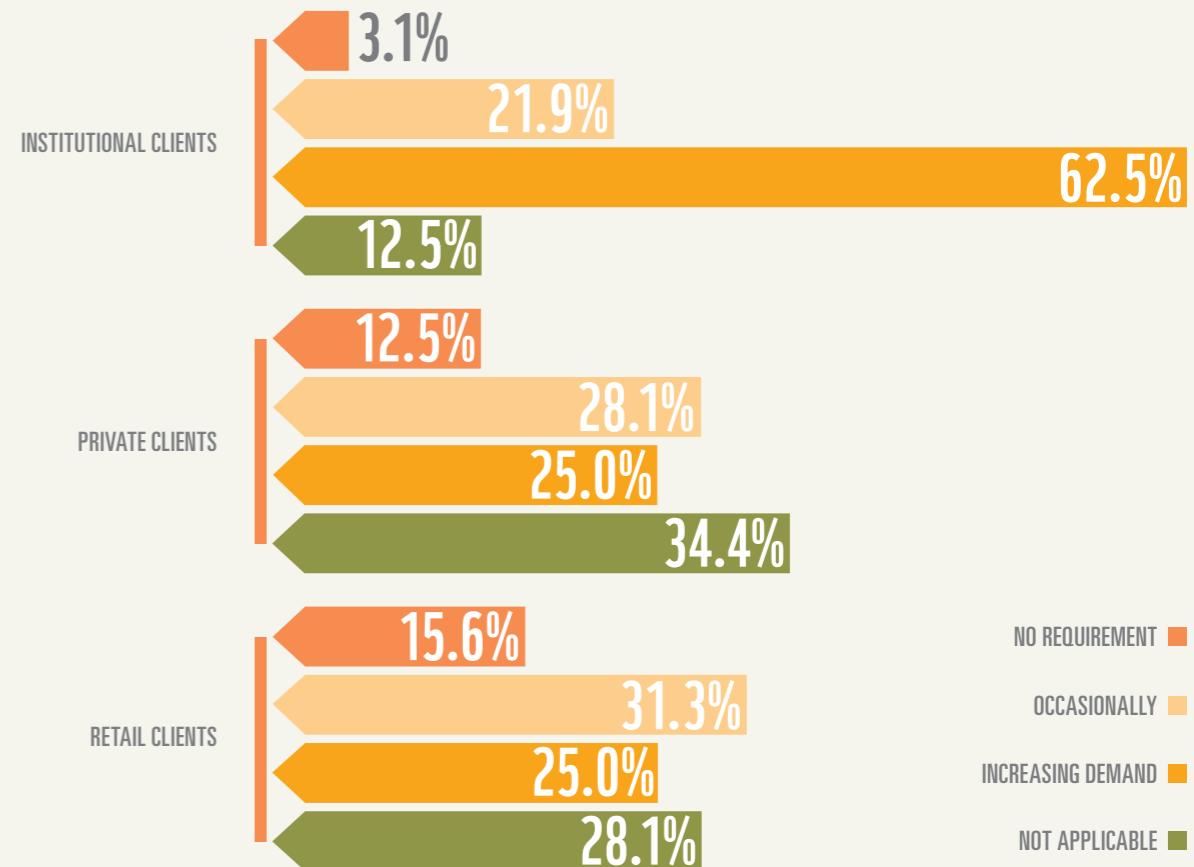
Passive investors such as index funds, quant funds and parametric investors are starting to show interest in new ESG overlays and metrics.

While not explored in sufficient depth in this survey, sector white lists, no-go blacklists and benchmark ratings and overlays all have a role to play in making some of the non-financial issues more accessible to these passive funds. The Norwegian Government Pension Fund Global's "list of excluded companies" is an example of an exclusion list used by a number of investors as part of their in-house screening. However, there are not enough of these accessible and credible exclusion screens.

Conventional investors without in-house ESG capabilities are beginning to recognize the environmental and social risks posed by high impact sectors such as palm oil and are actively looking at internal strategic options. A number of large investors targeted by the survey were not signatories of the UN-PRI and have not yet formulated a firm-wide responsible investment policy. However, there is evidence that these investors are beginning to shape their response to increasing client demand for ESG risk management. One UK-based institution with a global portfolio had recently set up an internal task force to review and implement an ESG strategy, but lacked specific expertise on issues around the palm oil sector. Recent acquisitions and consolidation within the investment management community make it challenging to integrate policies at a global level on a timely basis.

The demand for ESG screens is coming principally from institutional clients. Nearly two-thirds (63 per cent) of investors reported an increase in the demand for ESG screening from this client group. In contrast, private and retail client bases demand less ESG screening, as shown in Figure 4 below. More and more, ESG data is not being applied or required independently of financial analysis, but is used as a means of enhancing financial analysis directly. This trend will put increased pressure on conventional (mainstream) research analysts to find ways to rationalize this data in terms of its implications for stock market returns. In addition, the service level agreements between asset owners and investment managers may well include key performance indicators on ESG issues against which investment managers must report quarterly or even monthly.

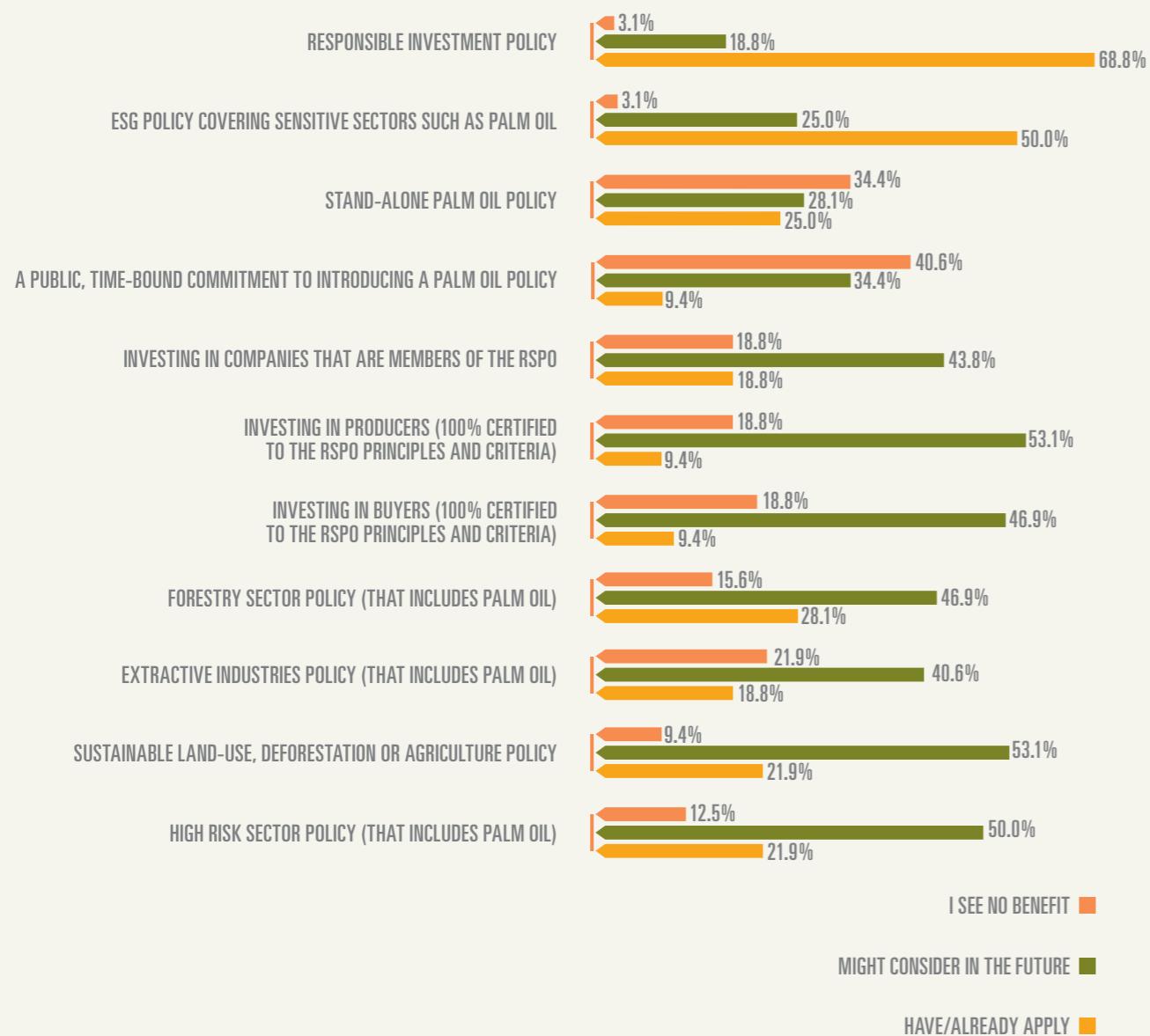
Figure 4 – Demand for ESG screening from clients



"If a title is added on a prominent blacklist such as the Norwegian Government Pensions Fund list, this would make it quite difficult to continue holding the title in the portfolio."

A large majority of investors who responded to the survey already had a responsible investment policy (see Figure 5). However, this was largely because the investors who responded tended to be those with an SRI bias. Few of the more conventional/mainstream investors had a public responsible investment policy that extended beyond governance. Of those surveyed, about half had an ESG policy covering palm oil issues. Interestingly, when asked about the future, including palm oil as part of a broader sustainable land-use policy was their main priority. Investors typically seek to move beyond adopting a simple responsible investment/ESG policy to creating dedicated policies that may be more applicable to the funds or sectors they invest in.

Figure 5 – Policies held by investors



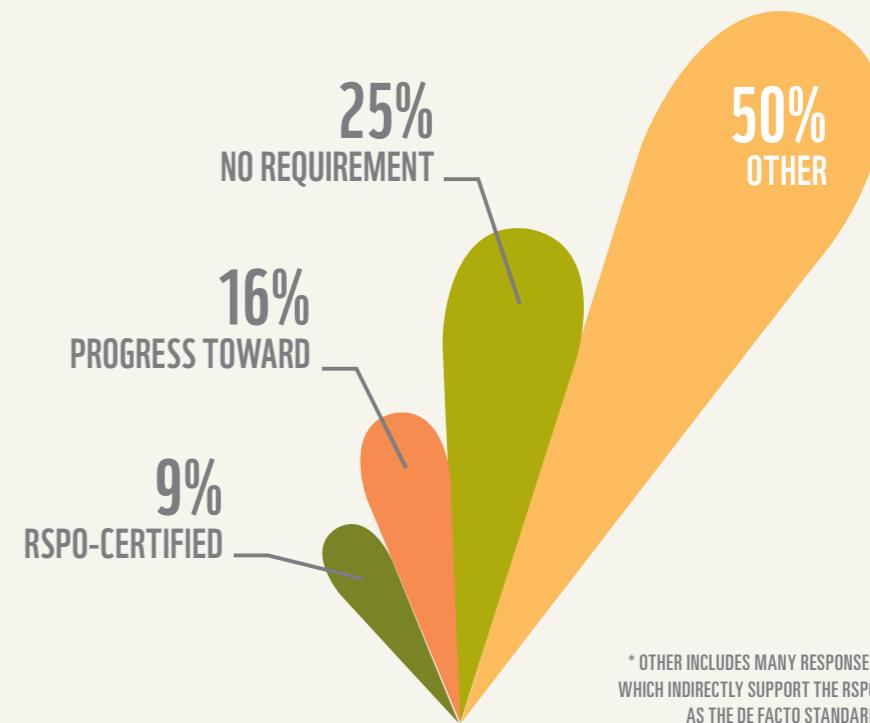
Screening for palm oil risks is seen as an integral element of a broader ESG screening process. While the majority of investors canvassed had investment criteria considering ESG factors, only two-thirds included palm oil as an aspect of those screens. Interestingly, screens could vary by portfolio and few investors had a dedicated palm oil sector policy. More often than not, they do the ESG screen only after the initial investment decision is made, which is based on the quality and valuation of a company; ESG screening is mainly done for SRI or screened funds. Investors typically draw on a mix of in-house and external screening services. Conversely, some investors do not use screens in their ESG analysis but instead use a “best-in-class approach”, which identifies and evaluates the most material ESG risks on a sector-by-sector basis. For passive funds, investors would apply screens if the client requested it.

The majority of investors use in-house screens (78 per cent) but a high proportion (56 per cent) relied on external services, including index sponsors or dedicated ESG research providers. Palm oil industry research produced by investment managers with equity ownership (buy-side research) or engagement services was seen as the most credible source because of its breadth of coverage, perceived independence and company access.

(4) INVESTORS' VIEWS ON THE RSPO, OTHER INITIATIVES AND REGULATION

Investors still see the RSPO as the de facto standard for investment screens. Investors see membership as a proxy of best practice and good management (see Figure 6) but increasingly recognize that membership on its own is not sufficient. Investors recognize that companies are often quick to sign up to the RSPO, but do not necessarily intend to follow through with changes, targets and progress reports. Investors are now increasingly looking for ways to hold companies to account.

Figure 6 – Requirement for investee company being RSPO-certified?

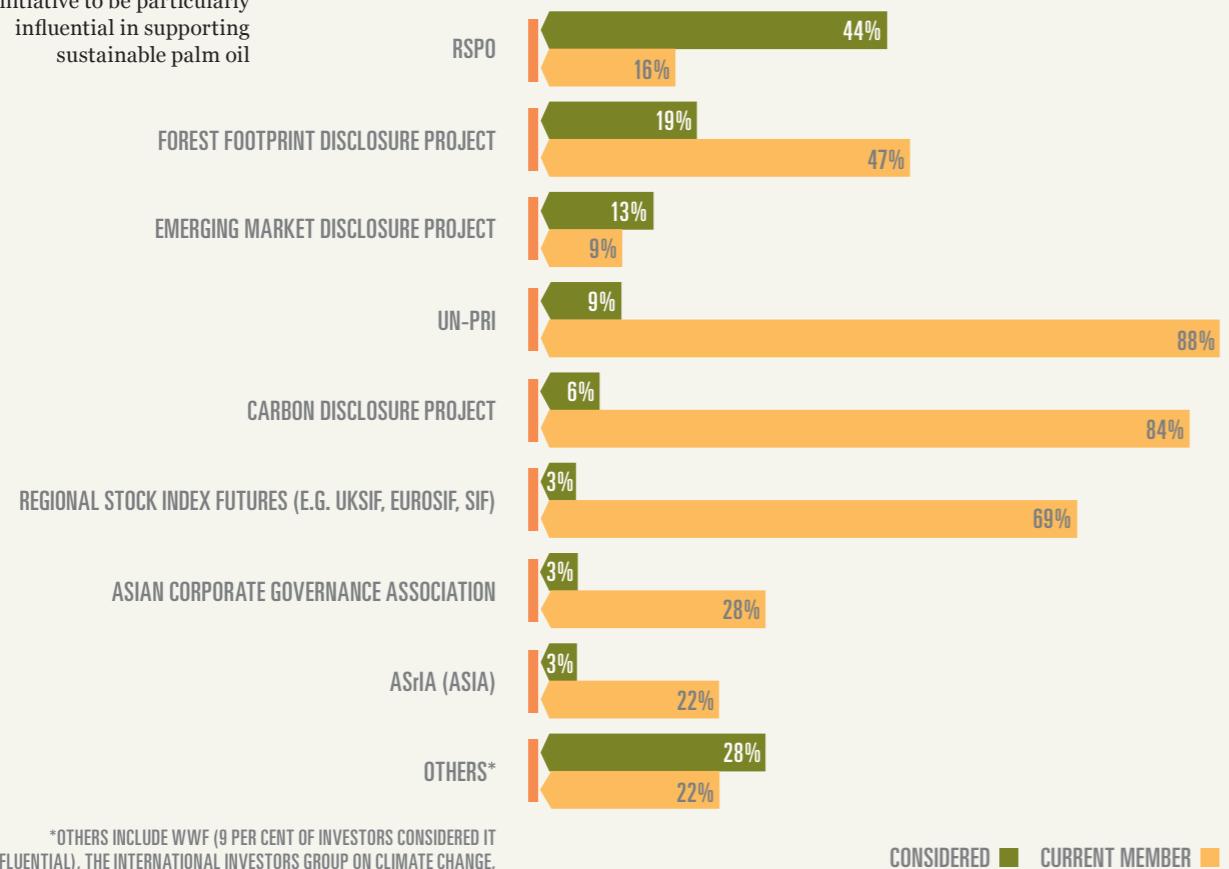


The RSPO is a consensus-based organization – a governance model which presents a big challenge where urgent change is required. Investors recognize this and are keen to support the RSPO, as shown by their recent efforts to collaborate (for example, in the UN-PRI IWG). Investors are keen for the RSPO to cover issues such as corruption and bribery at government and local level. Investors also want the RSPO to be given more credibility and support (“more teeth”). They believe that by supporting and engaging with what they see as the most credible standard in the market, the sector’s sustainability as a whole will improve.

As producer companies (where many investors are invested) have taken steps to move away from business-as-usual and have moved faster than palm oil buyers, there is currently an oversupply of CSPO. This makes the rest of the market reluctant to follow. The RSPO’s Code of Conduct requires its members to report their progress toward the RSPO mission. This helps with transparency and encourages continuous improvement in commitments to sustainability and engagement with stakeholders. Upcoming improvements to the way the RSPO presents and reports members’ data (for example, on its website) will help with disclosure and overall access to information.

As illustrated in Figure 7, investors see the RSPO as the most influential initiative promoting sustainability in palm oil production. Asset owners and investment managers’ increasing involvement in initiatives specifically looking at palm oil supply chains (such as the RSPO), as opposed to focusing just on plantations, demonstrates a new awareness of the importance of looking at whole supply chains when engaging with companies or managing risks across the investment portfolio.

Figure 7 – Percentage of investors who considered an initiative to be particularly influential in supporting sustainable palm oil



Investors need to be educated on specific high impact issues. However, they often just need simple tools that can be easily applied to their decision-making practices. If these tools come from a credible source, they can strongly influence the flow of capital at a macro level.

Investors want clarity on the best approach to drive sustainability in the market. The GreenPalm book and claim system (using tradable certificates for RSPO-certified palm oil but without physical traceability) is recognized as an effective way to get the CSPO industry off the ground and get producers to change practices. However, investors are increasingly worried that this system is not commensurate with the size of investment and commitment, and question whether it incentivizes the right behaviour.

The regulatory environment is a continual challenge for investors. Investors want to see better support for sustainable palm oil from regulators, both on the supply and demand sides.

- Indonesia and Malaysia are developing their own national sustainability standards, as legal compliance requirements – unlike the RSPO where compliance is voluntary. Yet the RSPO standard is the accepted benchmark with a healthy multi-stakeholder backing. This confuses investors and does not promote a unified approach.

- On the demand side there could be better sustainability criteria for what palm oil is used for.

- Legislation needs to be strong enough to control and demand production techniques the RSPO desires (for example, the EU Renewable Energy Directive).



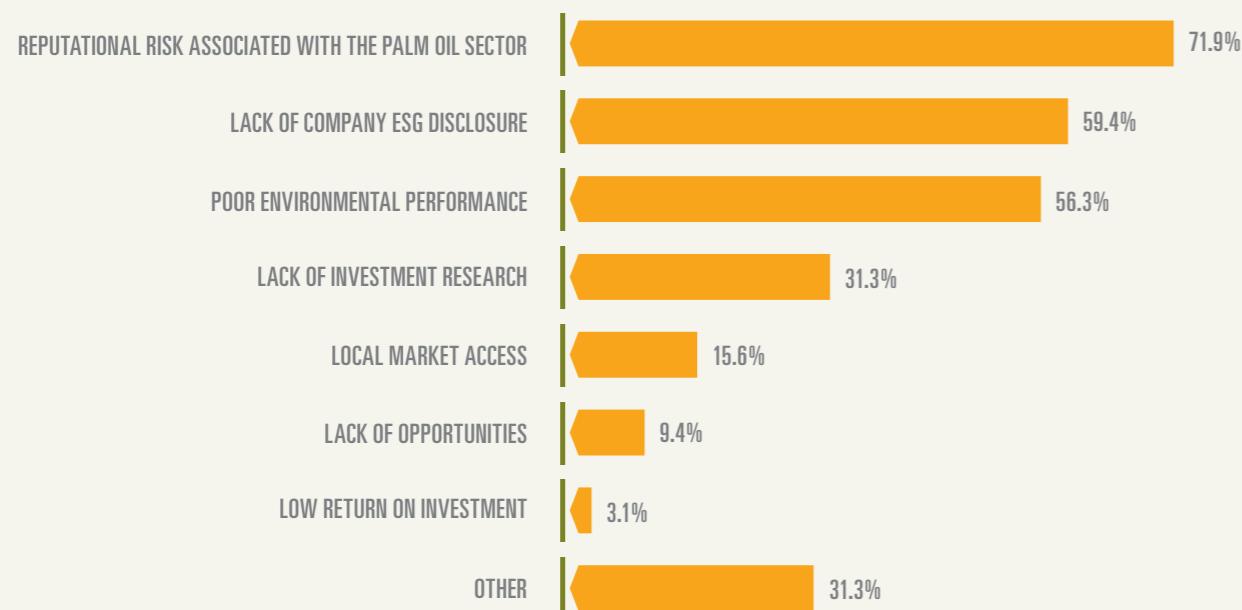
(5) INVESTORS' NEEDS FOR GREATER DISCLOSURE, ENGAGEMENT, TRANSPARENCY AND RESEARCH

Investors continue to see significant challenges to investing in the palm oil sector.

oil sector. Aside from reputational risks associated with the palm oil industry and related environmental performance issues, investors overwhelmingly see the lack of company ESG disclosure and poor coverage of investment research as being the key barriers to investing (see Figure 8). Other barriers include a lack of no-go screens, local governance and rule of law, and issues surrounding supply chain custody.

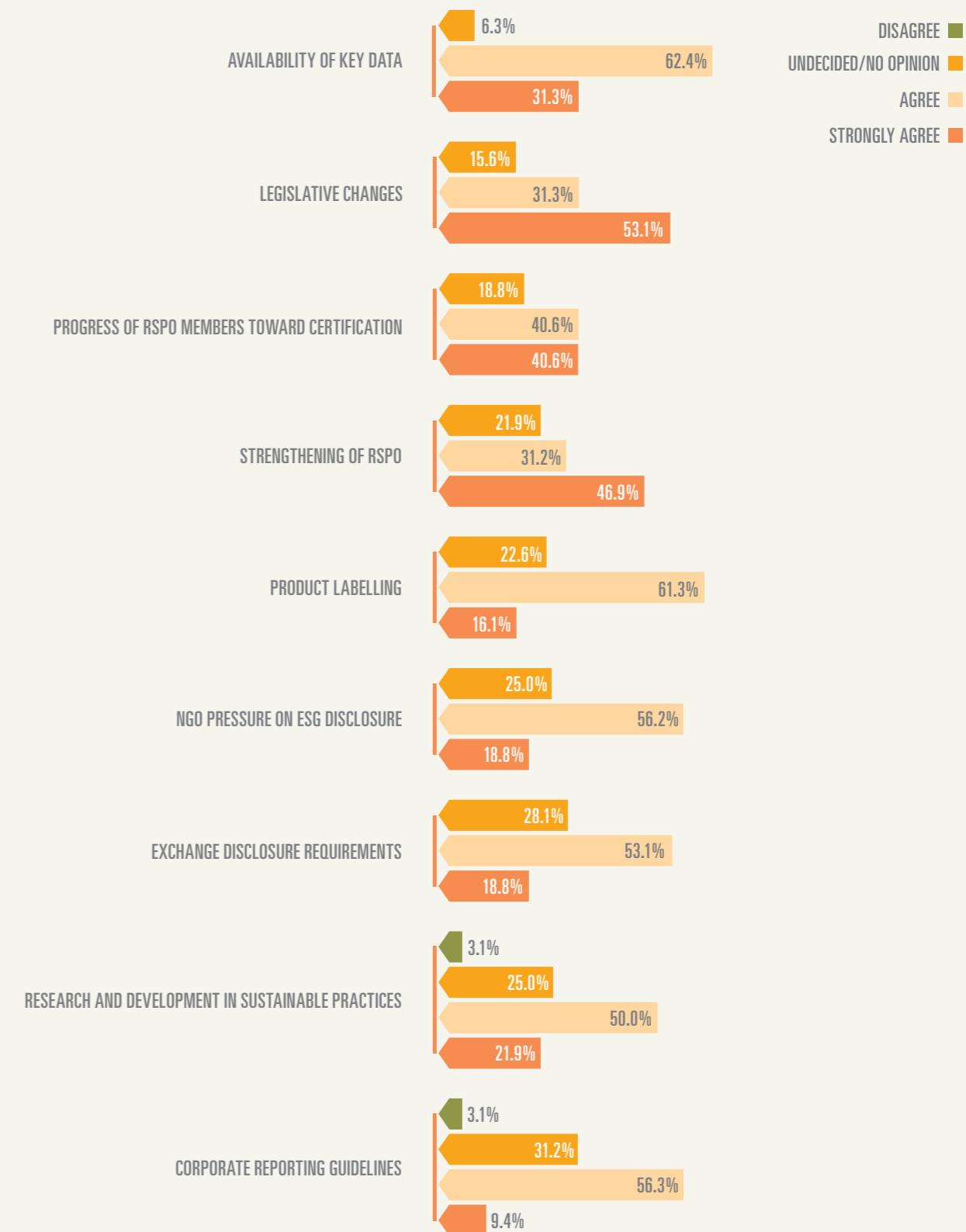
Legislative changes and strengthening the RSPO would be the most influential factors in getting more investment in palm oil, followed by demonstrable progress by RSPO members toward certification (see Figure 9 opposite). Overall, the availability and accessibility of key data were still top of the list. Opinions differed over the need for corporate reporting guidelines.

Figure 8 – Key challenges preventing investment in palm oil



"RSPO membership is a standard criterion but we are aware this is probably not enough. It is a sign of best practice and good management, so we would be more likely to invest in a company that is committed to the RSPO than one that is not."

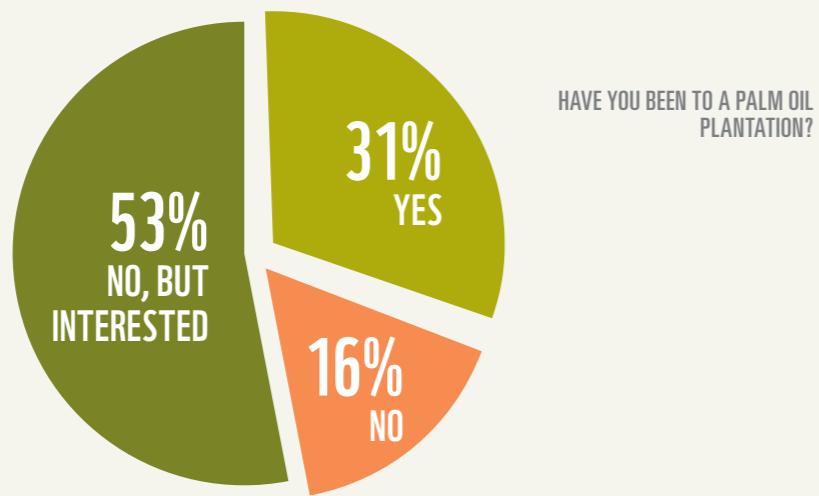
Figure 9 – What will have a material impact on increasing investment in palm oil?



Investment managers and analysts want broader, deeper, more reliable and timely data to gauge the sustainability of their investee companies' palm oil operations. Information is a key driver in an increasingly complex space. It needs to be made accessible and presented in a format that investors can readily use for their investment decisions. As ESG reporting becomes the norm, it is hoped that companies will start to provide consistent and comparable data on key performance indicators for benchmarking within the industry. To date, some palm oil companies have voluntarily reported on their ESG performance, but investors find that the quality and content of reporting vary greatly. The RSPO should help instigate a consistent and comparable data reporting process.

Access to management to discuss ESG issues is a problem for many investors. The remoteness of plantations makes it difficult for many analysts covering the sector to access management, let alone visit the plantations first hand. The message from emerging market investors was clear: there are few substitutes for meeting management (the stewards of their clients' assets) to candidly discuss the ESG issues facing palm oil. Figure 10 shows the keen interest that investors have in actual on the ground experience with their investee companies.

Figure 10 – Investors' ground experience

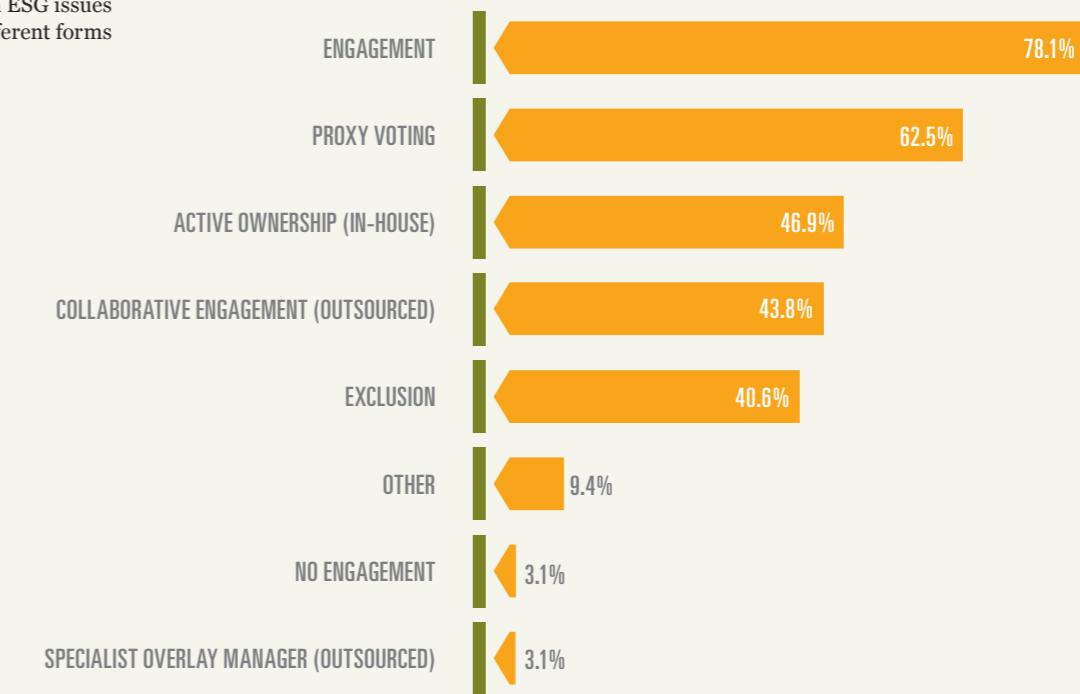


"The key is to promote sustainable palm oil practices one way or another, and educate buyers, investors and consumers that this is not necessarily a contradiction in terms. Many simply associate palm oil with deforestation and do not know (or want to know) anything beyond that, thereby not incentivizing responsible companies or investors to become linked to anything palm oil-related, even though they could play an important role in making the industry more sustainable."

Research required is often inaccessible through conventional commission-based research channels (buy-/sell-side); alternative funding mechanisms are needed. Following the *Myers Report* it was argued that transparency in indirectly funded research was needed, casting the spotlight on research providers who derive significant revenues from soft commission arrangements. Most institutions have a very limited budget for fees and subscriptions. In the UK, the Financial Services Authority has made clear its commitment to a level playing field for independent research, making specific provisions for an approved mechanism that would allow institutional investors to use commission payments to purchase research from outside vendors. In the US, the Securities and Exchange Commission has likewise clarified that it wants to make it as easy as possible for money managers to pay for independent research. Without a clear funding mechanism, it is a challenge for the smaller or regionally specialized research firms to access a broader investment base. Data providers (Bloomberg, for example) and organizations such as the UN-PRI have a crucial role to play in communicating and disseminating information.

On the whole, investors advocate engaging with investee companies over divestment. An increasing number of asset owners are largely outsourcing engagement with companies to specialist investment managers. However, some asset owners are moving toward more in-house engagement, focusing on material high risk factors (such as biodiversity). While a number had formalized processes of review, the process would typically end in divestment – a process that can “last one to three years and has to be conducted before considering exit” – presenting a strong signal to investee companies that the investors are willing to engage. In contrast, private equity investments are typically committed for over five years, making an early exit very difficult, but here it is often easier to influence and change the approach of a majority-owned company than with a listed equity.

Figure 11 – Percentage of investors currently engaging on ESG issues in different forms



Much of the engagement with plantation companies on ESG issues seems to take place on a one-to-one basis, rather than through shareholder coalitions. There may be a substantial opportunity for investors to engage collectively with plantation companies (and downstream buyers of palm oil) where interests overlap – such as through the IWG within the UN-PRI membership. A number of asset managers said they were sceptical about the effectiveness of engaging with local or national governments or other regulators in emerging markets. However, it is worth noting that a number of Western-based managers recognized the difficulty in accessing companies predominantly based in Asia and were open to exploring new ways of collaborating constructively with their peers.

Transparency across the industry is of paramount importance to investors, who are increasingly working with their investee companies on wider sustainability issues. Transparency applies equally to:

– **Buyers**, who are setting targets for sourcing 100 per cent CSPO. However, very few are articulating how they will achieve this. Investors need to see clarity around capital expenditure required to meet these targets.

– **Growers**, in terms of impact on bottom line of technologies and practices needed to meet sustainable production and costs of adopting the RSPO Principles and Criteria, which will likely reduce available land banks for production. Conversely, growers could be more transparent over the reduction in land disputes, labour stoppages and staff turnover to chart the benefits of certification.

– **The RSPO**, in terms of how it plans to enforce its Principles and Criteria. At the certified plantation level, third party and independent audits verify compliance with the RSPO standard. For non-certified companies and for group level commitments, self-verification through annual reporting is the only way to assess progress. For this to be sufficient, shareholders can help hold listed companies to account.

– **Local and regional governments**, in terms of supporting and not undermining voluntary sustainability efforts.

“We prefer engagement to divestment. Taking money away will not change things if the company can simply find that money elsewhere. On a side note, as a responsible investor, should you not look to divest responsibly as well?”

Trucks drive around the plantations collecting palm fruit to take back to the central mill for processing.



5. RECOMMENDATIONS AND NEXT STEPS

Investors and the RSPO have a crucial role to play and WWF will provide strong support

i. What investors need to do

As part of their research process, investors seek to engage with companies to inform their own in-house sustainability ratings alongside issues of risk management and buy/weight/sell decisions. By asking the right questions, investors should aim to highlight to companies their concerns about material ESG issues they believe can have an impact on the investee company. Sustainability is an important element of an investor's business, given emerging evidence across a range of industry sectors that it enhances shareholder value. Palm oil is just one of a number of commodities that share similar sustainability issues, so these recommendations should be considered as part of a broader strategy in dealing with food, fibre and biofuel commodities.

Within their own institutions, investors need to:

Quantify their exposure to palm oil, while recognizing that this information is not readily accessible but is publicly available for external parties to aggregate.

Include palm oil in their responsible investment policies and guidelines, and incorporate palm oil in broader ESG appraisals:

- Include palm oil ESG issues in investment and valuation analysis and decision-making processes by supporting the development of ESG-related tools and metrics and looking at internal benchmarking to assess the material risks;
- Engage broadly with research firms, rating companies, consultants and NGOs on how to integrate palm oil factors into research, valuation and analysis.

Individual ESG analysts should work more within their firms and in particular with their counterparts in Asia. Active investors who recognize the sustainability problems inherent in palm oil need to communicate internally.

Commission and fund independent research focused on the broad macro issues dealing with palm oil and related food, fuel and fibre issues/sustainable land use, including demand drivers from India, Indonesia and China – the three largest consumer markets for palm oil. There is a lack of quality research on material ESG risks and opportunities within the sector:

- For active managers, an investment thesis that ESG integration of palm oil issues may be alpha-enhancing would be appealing, as demonstrated in WWF's study on *Profitability and Sustainability in Palm Oil Production*.
- In addition to environmental issues, which are reasonably well documented, attention needs to be devoted to social issues such as labour and human rights and impact on indigenous communities, as well as governance issues (transparency, accountability and avoiding corruption and bribery). This may be more relevant to Asian investments.

- Ensure that data providers (companies like Bloomberg and Thomson Reuters, for example) and extra-financial data providers offer channels to disseminate independent research⁹.

Collaboratively, within the investment community, investors need to:

Engage with the RSPO so that the benefits of wider investor involvement for the RSPO are well understood by its membership. Conversely, the RSPO could explore how it should engage with investors to maximize the level of support they can bring to the RSPO and to the sustainable palm oil industry more broadly.

Table 5 below outlines the mutual benefits of greater engagement for the investor community and the RSPO. Some investors groups, such as the IWG, have been actively exploring membership and the collective role they can play to support the RSPO.

Work collectively on highlighting gaps in information and tools that would support better decision-making:

- Participate in collaborative engagement initiatives (such as the IWG);
- Communicate palm oil-specific ESG needs and expectations to research providers so they can tailor their services.

Table 5 – Investors and the RSPO: summary of benefits

BENEFITS TO RSPO	BENEFITS TO INVESTORS
<ul style="list-style-type: none"> – Representation from asset owners and managers who control a significant proportion of listed equities¹⁰ and can apply pressure on investee companies as shareholders; – The ability to hold businesses to account, thereby promoting the RSPO and strengthening its hand; – If an investee company is not signed up, the investors (as asset owners) can press for it to become an RSPO member, thus benefiting the RSPO in terms of increased membership; – Investors can broaden the current representation of the “Banks and Investors” category, which is principally led by commercial banking interests, and thereby improve discussion within the category; – The ability to apply peer pressure to other investors in the palm oil supply chain to engage with the RSPO and develop policies on screening investments; – Access to insights from financial members on ways to fund sustainability in palm oil. Currently issues around financial mechanisms to help deliver low carbon palm oil are being explored but new types of financial members are needed that are directly involved in these markets. 	<ul style="list-style-type: none"> – The ability to pressure investee companies to adopt sustainable sourcing and production practices by signing up to the RSPO Principles and Criteria; – The ability to influence and shape the ongoing role of the RSPO, such as improving communications, access to data, informing reporting guidelines (noting that only ordinary members have a voting role); – Direct access to key operational and sustainability staff in the most progressive and engaged companies in the supply chain; – Access to the latest on developments in sustainable palm oil; – Access to best practice among peers and competitors; – Better access to data for company engagement, supporting RSPO’s intent to promote transparency in the industry.

Drive sustainability reporting criteria around palm oil. This could be the focus of existing investor groups, taking the form of, for example, an open letter to palm oil producers (or the RSPO) to ask for sufficient disclosure for analysts to understand management approaches to sustainability. This type of request should also extend to buyers of palm oil.

Universal owners (such as large government or pension funds) could be more receptive to sustainability issues. Universal owners are large institutional investors who, because of their size, own a slice of the whole economy and market through their portfolios. As they have a financial interest in the wellbeing of the economy as a whole, they are inevitably exposed to both positive and negative externalities. They can positively influence the way business is conducted to reduce these externalities and reduce their overall exposure to growing costs from environmental damage. Universal owners have the most to gain from sustainability but perhaps do not have the resources to act alone on these issues.

Externally and publicly, investors need to:

Be active owners, incorporating palm oil ESG issues into ownership policies and practices; actively engage with their investee companies in the palm oil supply chain to encourage them to join the RSPO; and push for better disclosure of volumes and commitments. Investors should apply this approach to upstream growers and plantation owners, and pay extra attention to the expansion of plantations and mills which pose a greater risk to sustainability.

The investment community is facing growing calls globally to act as responsible asset owners and managers by investing and engaging with companies with the objective of pursuing long-term, sustainable value and delivering effective risk management. Leading pension funds and long-term investors have long understood that environmental, social and governance issues can impact a company's performance and risk, and as such those companies that fail to recognize these issues can be at a disadvantage in terms of long-term cost of and access to capital.

The development and growth of the UN-backed Principles for Responsible Investment Initiative has helped to formalize and embed this approach into mainstream analysis, as demonstrated by the significant size of the assets under management of the global institutions supporting the UN-PRI. As part of this process, companies and their investors must discuss these issues in the context of materiality to their strategies and performance and support more focused disclosure of ESG opportunities and risks, for example through integrated reporting.

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Mark Mills, Partner — Generation Investment Management LLP and RSPO Ordinary Member

Palm fruit, having been harvested, is piled up to be weighed.



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They should also apply this approach to downstream buyers (processors and traders, manufacturers and retailers), urging them to commit to buying CSPO. This will alleviate growing concern in the investment community about lack of disclosure around plans to meet commitments to sourcing 100 per cent CSPO by 2015, and provide longer-term support for transitioning toward fully segregated supply chains (less reliance on GreenPalm certificates).

This should include the following actions:

- Engage with investee companies on material issues as they arise as well as on stepwise progress to mitigate ESG risks in their operations;
- Disclose publicly the firm's stance around active ownership;
- Support their palm oil grower investee companies to make the necessary investments and changes in corporate planning, culture and practices so as to embed sustainability into their core strategy and operations;
- Exercise proxy voting rights;
- Ensure analysts have access to independent research on all votes (through input from independent governance experts, for example);
- Ensure transparency when taking action on palm oil ESG issues. The fragmented nature of asset ownership in the sector means that one investor alone will not be influential enough to ensure change. Only if multiple investors are seen by the investee company to be focusing on ESG issues will a critical mass of pressure be achieved;
- Put pressure on investee companies to publicly disclose their own engagement on ESG issues with stakeholders and the investment community.

Put pressure on exchanges to mandate the adoption of minimum reporting requirements for high impact sectors such as palm oil. Stock exchanges have so far been cautious, preferring voluntary disclosure. However, going forward there

will be increased pressure for disclosure and verification (around climate resilience, for example). Linking in good stewardship and long-termism will provide an opportunity for better disclosure from corporations.

Explore ways to further develop the demand for CSPO through market mechanisms.

For example, potential trading in CSPO futures (once there is sufficient traded volume) to allow index funds to do their part for sustainability. The industry needs a segregated investible market for CSPO while avoiding negative issues linked to driving up global food prices and volatility.

ii. What WWF will do

We see the financial sector as an important lever to enable more sustainable palm oil production and trade. We have been active in the palm oil financing arena for the past five years, developing the following publications:

- *Palm Oil Financing Handbook*
- *Profitability and Sustainability in Palm Oil Production*
- A guide to responsible financing, procurement and production of soft commodities (to be launched later this year)
- *Palm Oil Investor Review*
- *Commodity Update Quarterly Newsletter*

On the basis of this report, WWF will:

Continue to inform the market and investors about the opportunities and material ESG risks in the palm oil sector:

- Convene workshops/forums and investor road shows with strategic partners and others to disseminate information on ESG issues, BMPs and market opportunities to the broader investment community;
- Continue to share tools and guides with financial institutions.

Engage with investors both on a one-to-one basis and collectively.

Work more closely with investment consultants on issues that could materially influence asset allocation strategies.

Support development of trustee guides on key issues in the sector. **Work with responsible investors on developing tools** that support scrutiny of the sector and provide guidance to mainstream investors.

Provide frequent updates on relevant research, keeping the investment community up to date with WWF and others' research and activities (via WWF's *Commodity Update* newsletter).

Work with our finance sector partners globally so that they are up to date on palm oil ESG issues and fully able to incorporate the best ESG risk management tools and approaches in transactions where palm oil is relevant. We will also highlight emerging opportunities to support sustainable palm oil businesses.

iii. What the RSPO should do

Develop, gather and publish uniform ESG performance data that investors can use to inform their decision-making.

Undertake awareness raising and more in-depth education for its financial members about the palm oil sector, ESG issues and its progress, as well as the costs and benefits of certification.

Help its financial members to **share and develop best practice analytical and investment tools**.

Be flexible in its membership costs in relation to investors that hold relatively minor assets in palm oil. An ordinary membership fee for organizations within the palm oil value chain (including NGOs) is €2,000 per annum. The RSPO does allow applicants to argue for reduced membership fees – but only if the potential member can show that their financial situation warrants it.

Clarify what the RSPO requires in terms of commitments and actions to transform the palm oil industry. RSPO members sign a Code of Conduct when they join under which they must support the RSPO and promote CSPO. To date, how financial organizations can do this and how their progress can be measured has been unclear. The RSPO needs to develop a set of actions that it expects from its financial members and ensure that it monitors and reports on progress against these.

Table 6 – Summary of what individual stakeholders should do

STAKEHOLDER	ACTION
Asset owners	Refine Requests for Proposals to include ESG and palm oil specific criteria.
Asset managers	Engage collaboratively with their Asian counterparts.
Buy-side analysts	Fund detailed coverage from specialist research providers.
Sell-side analysts	Include material ESG risks and opportunities into their analysis.
Investee companies	Respond to analyst requests for ESG metrics being reported.
Financial intermediaries	Support decision-making tools with impactful reporting.
Extra-financial research providers	Supply regular and consistent ESG content beyond questionnaires.
Market data providers	Embed metrics and key performance indicators for CSPO.
NGO community	Provide succinct key performance indicators, tools and research.
RSPO	Work on data transparency.

Abbreviations

AUM	Assets under management
BACP	Biodiversity and Agricultural Commodities Program
BEI	Banking Environment Initiative
BMPs	Better Management Practices
CSPO	Certified Sustainable Palm Oil
ESG	Environmental, Social and Governance
GHG	Greenhouse gas
IFC	International Finance Corporation
IWG	Investor Working Group
OECD	Organisation for Economic Co-operation and Development
RSPO	Roundtable on Sustainable Palm Oil
SRI	Socially Responsible Investment
UN-PRI	United Nations Principles for Responsible Investment Initiative

References

¹For example, WWF, FMO and CDC have recently done research on the business case for sustainability in the palm oil sector.

²Koh, L.P. and Wilcove, D.S. 2008. Oil Palm: Disinformation Enables Deforestation. *Trends in Ecology and Evolution*, 24.

³Estimate from Indigenous Peoples Alliance of the Archipelago, or AMAN Aliansi Masyarakat Adat Nusantara – an organization of indigenous peoples across Indonesia.

⁴Various, including United Nations Environment Programme/Freshfields Bruckhaus Deringer. 2005. *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment*.

⁵As of November 2011.

⁶See EiRiS research in particular.

⁷OWW consulting 27 May 2011.

⁸Eurosif 2010 European SRI Study. Calculated from changing €7.6 trillion into dollars according to the September 2010 average monthly exchange rate of \$US 1.3067 to €1.

⁹We note that Bloomberg recently launched “BMART” as a channel for research data and news, where independent research providers can sell research products via the terminal.

¹⁰Not forgetting the role of private equity, debt holders and other investors.

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Investors have a crucial role to play in highlighting that companies which integrate sustainability into their core strategy and operations:

- Are better able to mitigate risks and exploit opportunities;
- Derive business benefits;
- Can access a broader pool of capital;
- Deliver better investment performance.

WWF is working with a range of financial institutions and producers to make this case more explicit and more widely recognized. This report is one of a series that we have produced in recent years.



Why we are here

To stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature.

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