Palm oil investing through an ESG lens

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Does investing in palm oil companies pose a controversy or present an opportunity? Here is a deep-dive analysis of the palm oil sector and the material ESG issues facing it. All in all, we believe that positive ESG changes represent a strong opportunity for palm oil companies, and we look for candidates that strive towards sustainability goals and exceed their ESG targets.

By Kenneth Tang, Senior Portfolio Manager

Boon and bane of palm oil investing

The starting point for Environmental, Social and Governance (ESG) criteria in palm oil investment can be somewhat contentious given the industry's perceived links to environmentally unfriendly practices, such as deforestation and land erosion, in addition to poor labour standards. All this makes an objective assessment of ESG criteria-based investing in the palm oil industry particularly difficult.

A commonly used vegetable oil, palm oil is most known for its versatility and high crop yield. The oil, however, is often linked with negative social and environmental issues, such as the large amount of greenhouse emissions and land deforestation that occur as a result of palm cultivation. Palm oil has also in recent years been linked to labour exploitation, highlighted by an import ban on two Malaysian palm oil companies by the US Customs and Border Protection (CBP) agency on allegations over forced labour practices.

This leads us to instil a more vigorous internal assessment of ESG in our investment process of palm oil companies. In our view, it is of paramount importance to understand the key materiality issues facing the palm oil sector and their impact on future investment returns. Due to our underlying philosophy of integrating ESG criteria in our stock analysis, we strongly believe that having a robust and improving ESG framework is fundamental for companies that want to achieve and sustain high returns. We believe that the most important aspect of the ESG criteria is the impact it has on companies towards making their returns sustainable.

We apply rigorous fundamental research to identify companies that are capable of achieving high and sustainable returns and/or positive fundamental change. We also believe that investing in companies with these characteristics will deliver superior performance over the long term.

ESG evaluation process

Our ESG evaluation process starts with identifying the key material issues for shareholder returns for each company we cover. These issues could be risks to returns, which include potentially disruptive events and risks that lead to a gradual erosion of shareholder returns. They also include ESG-related opportunities that could result in a material enhancement of shareholder returns. We further access the scorecards for the palm oil companies in the following issues of materiality, which we believe are the most important issues for ESG and sustaining returns. The issues of materiality are: 1) emissions and energy management, 2) land, 3) biodiversity and 4) labour management.

In emissions and energy management, we focus on rehabilitation plans for peatland, which is used extensively in southeast Asia for industrial agriculture; commitment from the company and its suppliers to a "no burning" policy of not using fire to clear land; disclosure on data management in monitoring fires; and commitment to measure and reduce emissions over a specific time period.

Within land, we focus on the company's ability to conduct proper assessment and mapping of the plantation's estate and areas for conservation sites. We also look at traceability of palm oil through the supply chain from point of origin of plantation to the refinery. Finally, we consider the certification compliance of RSPO (Roundtable on Sustainable Palm Oil[1]) for the company's estates and mills, and the timeline expected for the ability to achieve full RSPO certification. (A RSPO certification verifies that the standard of palm oil production from a company is sustainable.)

Regarding biodiversity, we identify sustainable palm oil companies by evaluating their commitment towards zero deforestation and if this extends to their suppliers. We also consider the restoration plans of these companies and whether they address non-compliant areas and conversion timelines for plantations and suppliers to reverse deforestation.

In the area of labour management and development, we focus on the labour conditions of workers in the plantations and assess wages and other ancillary costs, such as insurance and accommodation. We also look specifically at the support schemes for small holders or contract farming (plasma[2]) practices in assessing the labour standards of the companies.

Once we identify these issues, we evaluate the ESG performance of the palm oil companies with regard to each issue and assess how firms are mitigating risks and accessing ESG-related opportunities. In recent years, palm oil companies have accelerated their sustainability goals by improving palm traceability, complying with RSPO standards and increasing their commitment towards NDPE (no deforestation, no peat and no exploitation). Some companies have extended such commitment towards their suppliers, holding them accountable by applying similar sustainability standards. This internal evaluation then feeds into our overall rating of sustainable returns and fundamental change for the companies.

Finally, we address the key issues for continuing engagement with the companies we cover. These include outstanding ESG issues that companies are in the process of resolving or opportunities that are being developed. If appropriate, we will suggest options that best enhance shareholder returns. For example, we have challenged palm oil companies to materially improve their reforestation and conservation efforts to reverse the impact industry has had on the environment. Our general observation is that efforts towards sustainability by palm oil companies have accelerated over the past year, mainly though greater efforts to publish sustainable policies and time-bound targets to achieve full compliance; we are also seeing industry participants making an effort to stop buying from suppliers and plantations that do not meet the sustainability criteria.

PRI working group on sustainable palm oil

We engage the palm oil industry through two channels. The first is through individual engagement with palm oil companies and the integration of these meetings into our investment process and ESG risk assessment framework. The second is through our participation and support of the United Nations Principles for Responsible Investing (PRI)'s working group for sustainable palm oil. We have been a participant since 2018, taking part in a collective effort by investors to engage in palm oil matters and accelerate sustainability.

Being a signatory of the PRI, we are committed to its six principles for responsible investment to support as well as express our commitment to the conservation of the global environment and the development of a sustainable society through asset management.

The PRI working group helps its participants engage with ESG topics in the palm oil industry, develop guidance documents and drive collaborative initiatives. Since joining the working group in 2018, we have helped lead efforts with the primary objective of highlighting the key risks and ESG issues of materiality and encouraging companies to support sustainable practices in palm oil. Such collaboration enables us to champion sustainability efforts and enhance our ability to better influence palm oil practices and sustainability matters within a collective framework.

[1] Formed in 2004 to set a global certification standard for sustainable palm oil production. The organisation has nearly 5,000 members worldwide.
[2] A practice commonly practiced in Indonesia in which food processing companies subcontract crop cultivation to farmers.

Being part of the PRI working group has been rewarding as it helped us achieve three positive outcomes as an institutional investor.

The first benefit is that it has enabled us to be part of a unified investor voice supporting sustainable palm oil practices. The group's efforts are now gaining traction, and we see greater momentum as new members join this working group. We believe that likeminded asset managers working together will be stronger as a collective voice of engagement, and the more structured, focused and collaborative approach will result in better outcomes from the group's meetings.

The second benefit is being able to provide a platform for positive ESG change for investee companies within their palm oil supply chain and ecosystem. When the PRI working group was first formed, its engagements were with the industry's prime companies, but discussions have now extended to the broader palm oil supply chain, involving sectors such as financing (banks) and customers (fast-moving consumer goods companies). This has in turn provided palm oil companies with greater incentive to respond to and accelerate sustainability efforts, become more transparent and improve their ESG standings with their investors.

The final benefit is being able to facilitate a good feedback loop on "consensus", which can help portfolio managers better calibrate ESG commitments and see how they are aligned to investment return, namely total shareholder return. Collaborative engagement is also a good price discovery exercise in finding consensus and better understanding the sector's risks from different perspectives. This opens the discussion for greater change and alignment towards sustainability from various viewpoints. The information collected can form a strong PRI data repository and further strengthen our internal data bank for ESG engagement, allowing us to refine our materiality maps, issues and scoring.

ESG change and sustainable opportunities for palm oil companies

Our philosophy in ESG investing is to harness ESG-driven change in palm oil companies. To achieve that goal, our aim is to identify the positive changes and investing opportunities within palm oil companies that are in line with our ESG risk framework.

One of the key sustainability challenges for palm oil companies is managing engagements and compliance not just in the plantations they own but within the greater palm oil supply chain. This is of particular concern for palm oil refiners and traders, as much of the raw material originates from numerous independent suppliers, which make it very difficult to fully trace the origins of the material and associated sustainability practices. However, we have seen positive changes; palm oil companies are making a greater effort to realise the benefits of sustainable palm oil and large palm merchandisers are exerting greater influence to drive sustainability. For example, a large palm trading company estimated that about 10-15% of its suppliers do not meet sustainability criteria such as RSPO, and it has since stopped its business with the non-compliant suppliers. The company also estimated that 20-30% of palm oil in Indonesia and Malaysia are non-NDPE compliant and has implemented a formal sanction policy against non-compliant suppliers. The company hopes to bring the NDPE industry benchmark to 100%, and we see the greater influence and bargaining power of large palm merchandisers initiating ESG-related change and improving standards of sustainability.

Labour management and social issues are fast becoming an increasing area of materiality, relative to issues of emissions, land and biodiversity. For palm oil companies, their reliance on labour and the management of foreign workers remain one of today's largest challenges in the area of ESG materiality. On average, labour accounts for up to 40% of a plantation's overall operating costs and is a material component of palm oil profitability. Scrutiny over labour practices and workers' well-being has intensified in the wake of recent events such as the import ban on two Malaysian palm oil companies by the US CBP agency on allegations over forced labour practices.

We believe palm oil companies today need to be transparent over work practices their workers are subject to and the accommodations they are provided with in order to avoid allegations of labour exploitation. In addition, there is also greater focus on social contribution and development given the large employment role palm oil companies play in agrarian communities. Companies that invest in, and also better articulate their social development agenda in labour welfare, education and worker support will be in a stronger position to meet the sector's future sustainability targets.

Finally, transparency is key to improving ESG compliance in the sector. Companies that have led in setting clear sustainability targets have raised the bar for ESG compliance and act as drivers of positive change. Thanks to ESG ratings and rankings accorded by index providers such as MSCI and DJI Sustainable Index, disclosures by palm oil companies have become more transparent. We often take a positive view from an ESG perspective of companies that take leading roles in transparency and disclosure.

Pertaining to policies and disclosures, we look for palm oil companies with clear targets on land use and high conservation value (HCV) data, which is often reliable in mapping the scope of coverage and compliance. In short, sustainable palm oil companies should have good reclamation policies for disturbed land and clearly show how they are working with external stakeholder groups to verify their sustainable standards. A palm oil company associated with positive change, for instance, is one that has a comprehensive rehabilitation programme to restore disturbed land into forests, while quantifying the biodiversity and community impact of their plans. Close coordination with agencies such as Nature Conservancy, the World Wildlife Foundation and the World Bank also allows companies to receive good reference or benchmark data. Biodiversity represents a strong opportunity for positive ESG sustainability practices and change; palm oil companies that actively reverse or minimise land disturbances by rehabilitating conservation areas and improve the environment for wildlife populations are good examples of positive ESG change that can occur in the sector.

Summary

ESG remains a key pillar of our assessment of the sustainable returns and fundamental change characteristics of the companies we research. In the palm oil industry, our ESG analysis has revealed emissions and energy management, land, biodiversity and labour management to be the key issues and areas of materiality—all of which we believe are most pertinent to shareholder returns for the foreseeable future.

Being a participant of the UN PRI working group for sustainable palm oil has been beneficial for our engagement with the industry, namely the ability to be part of a collective investor voice in support of sustainable palm oil practices. Synergies from being part of this platform also help drive positive ESG change for investee companies within their palm oil supply chain and ecosystem; it also strengthens our internal assessment of ESG matters by enabling us to better understand consensus within the industry.

In our view, ESG compliance across the palm oil supply chain, labour practices, transparency and disclosures about policies and the link between ESG and financial performance all represent the major issues affecting positive ESG-related changes for palm oil companies.

We believe that managing ESG-related issues as an active manager is about understanding the industry norms and identifying what matters the most in influencing shareholder returns from an ESG perspective. As such, being active is about being proactive to identify positive ESG change in a company which is pursing sustainability and addressing the material issues to improve total returns, in our view.

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