

## SYSTEMIC APPROACHES TO ADDRESSING PALM OIL FINANCE

Palm oil is an inexpensive and highly versatile oil derived from the fruit of the oil palm tree. It is found in half of all consumer goods<sup>i</sup> (World Wildlife Fund, 2017) on the shelves today in Western grocery stores – from chocolate, ice cream, and baked goods to soaps, lotions, and detergents. Palm oil is also used as a petroleum substitute (a biofuel) to power vehicles, heat homes, and manufacture plastics. Palm oil plantations produce more useful oil per unit of land than any other crop. Due to its high yields and many uses, palm oil is the most actively traded edible oil in the world.

With annual sales of \$50 billion, palm oil is big business (Rushing & Chiu, n.d.).<sup>ii</sup> Indonesia and Malaysia have expanded their plantations and tripled production over the past 15 years, and today they account for 85 percent of global production. Indonesia's palm oil estate has gone from 1 million hectares in 1990 to 21 million hectares in 2015.

Palm oil has been identified as a driver of both tropical deforestation and climate change (Steinweg, Kuepper, & Thoumi, 2016).<sup>iii</sup> Palm oil expansion often has material financial risks from its environmental impacts and associated human rights abuses. In 2012 alone, Indonesia lost 840,000 ha of primary forest (Margono, Potapov, Turubanova, Stolle, & Hansen 2013),<sup>iv</sup> the largest loss globally. The rapid expansion of palm oil production in SE Asia has also been connected to serious human rights violations (Skinner, 2013),<sup>v</sup> including child and forced labor, now a regulatory concern for the U.S. Department of Labor (Bureau of International Labor Affairs, 2016).<sup>vi</sup> Migrant palm oil workers are often discriminated against and exploited. Palm oil jobs are often casual or seasonal jobs, creating financial stress for job seekers once employment ends. Palm oil creates fewer jobs hectare compared to cocoa, rubber, rice and agroforestry (Kuepper, Steinweg, & Thoumi, 2016; Rhein, 2015).<sup>vii,viii</sup>

Gender issues are also a significant financial concern to palm oil companies. For example, a recent survey of the 21 Indonesian companies in the Indonesian Agriculture Index found that women comprise 5 percent of these Boards. But 19 million women work in the Indonesian Agriculture, Forestry and Fisheries sector, fully 50 percent of this sector's labor force.

Green Commodities Programme (GCP) demonstrated that providing Indonesian women the same access to financial and technical knowledge as men, agriculture yields on agriculture plantations could increase 20 percent to 30 percent. McKinsey stated that "Indonesia needs to raise productivity per farmer by 60 percent just to meet domestic demand" (Chain Reaction Research, 2016b).<sup>ix</sup> The Center for International Forestry Research (CIFOR) reported that Indonesian women who work in the agriculture sector are the "treasurers of household funds" (Chain Reaction Research, 2016b).<sup>x</sup>

Many countries seeking palm oil finance are fragile states with a need for investments (Kuepper et al., 2016).<sup>xi</sup>

Key systemic financial risks facing palm oil include:

- Operational Risks: Investments are threatened when key risk management lessons are not applied. Government assurances are insufficient when landbanks are contested.
- Stranded Assets Risk: Contested land banks reduces present value of future cash flows resulting in negative pressure on financial valuation.
- Financial Risks: Failure to obtain Free, Prior and Informed Consent (FPIC) disrupts cash flows. For example, every SE Asian Liberian investment has been subject to delays, community conflicts and complaints filed with the Roundtable on Sustainable Palm Oil (RSPO).
- Reputational Risk: Violations of buyers' procurement policies and financiers' ESG criteria damage companies' reputation. This increases revenue-at-risk, earnings volatility, and cost of capital. IOI Corporation's earnings went from positive \$30 million Q2 2015 to negative \$14.8 million Q2 2016 because they violated their buyers' procurement policies.
- Regulatory and Procurement Risks: Companies relying on landbank conversion may no longer be compliant with buyers' procurement policies. In December 2014, the Government of Peru ordered United Cacao's Cacao del Perú Norte S.A.C., Plantaciones de Ucayali S.A.C., and Plantaciones de Pucallpa S.A.C. to cease operations because of illegal deforestation. The London Stock Exchange delisted United Cacao February 8, 2017 (Kuepper et al., 2016; RNS, London Stock Exchange, 2017a).<sup>xii, xiii</sup>

Palm oil production is growing in Sub-Saharan Africa and Latin America. Little arable land remaining in Indonesian and Malaysia. Capital is seeking growth opportunities elsewhere. Other countries are expanding their palm oil investments, as global demand is expected to grow.

In the Democratic Republic of Congo, in 2016, Feronia had a successful equity raise with the CDC Group PLC, UK Government Development Finance Institution and African Agriculture Fund, through its subsidiary Golden Oil Holdings Limited. These funds will be used to provide working capital to expand the former Unilever assets in the Democratic Republic of the Congo.

In 2016, the Government of Cameroon nationalized the Cameroon Development Corporation (CDC). CDC is now solely owned by the government. It operates under technical supervision of the Ministry of Agriculture and Rural Development. CDC is the nation's largest state-owned agribusiness and the second largest employer in Cameroon,

employing 22,000 people. CDC stated it will increase its palm oil production 67 percent by 2020, from 270,000 metric tons to 450,000 metric tons. Annual consumption in Cameroon is 385,000 metric tons. The Government of Cameroon set price controls on palm oil and palm kernel oil estimated at €0.69 per kilogram for industry sales. In 2015, the government banned Indonesian and Malaysia palm oil imports.

But palm oil development in Cameroon has problems. In September, 2016, 244 farmers filed two collective complaints against SG Sustainable Oils Cameroon (SGSOC). The complaints allege SGSOC of land grabbing. SGSOC's 20,000 hectare palm oil plantation alleged occupies lands belonging to farmers. SGSOC had failed to obtain FPIC from the farmers. Some of these lands are also considered High Carbon Stock and/or High Conservation Value forest.

SGSOC's palm oil plantation was formerly owned by Herakles Farms (Deugoue, 2016).<sup>xiv</sup> Herakles was financed partially by the Blackstone Group (Mousseau, 2012)<sup>xv</sup> through its subsidiary Sithe Global Power. This relationship is not transparently described within security filings (Thoumicfa, 2016g).<sup>xvi</sup>

Nigeria has taken a different approach. While it has a prohibition on importers of palm oil, it also prohibits importers using foreign exchange reserves to finance in-country palm oil projects. As a result, Nigerian grower Presco saw their revenue in H1 2016 increase 60 percent to \$24 million. But domestic companies have been unable to purchase agro-chemicals and required equipment given their lack of foreign reserves. Nigeria's palm oil production has remained at 970,000 metric tons annually since 2012 (Thoumicfa, 2016d).<sup>xvii</sup>

In 2016, ING raised €80 million in debt for Société Financière des Caoutchoucs SA (SocFin). The debt issuance was for senior unsecured 4 percent 5-year debt to finance land-use expansion for its vertically integrated palm oil and rubber production. Funds were assumed to be used to finance SocFin's expansion in Sierra Leone and elsewhere. ING facilitated this first public debt offering by SocFin. It is unknown if ING's participation required SocFin to include ESG safeguards into the use of funds. ING is a RSPO member (Thoumicfa, 2016l).<sup>xviii</sup>

CDP 2016 recently published its Global Forests Report (CDP, 2016)<sup>xix</sup> analyzing corporate risks and opportunities linked to the four commodities – soy, timber, cattle, and palm oil. These commodities drive the majority of tropical deforestation. CDP's report demonstrated that there is \$900 billion revenue-at-risk annually linked to deforestation. The report is based on self-reporting by 187 companies in 2016. These companies on average had 24 percent of their revenues dependent on commodities linked to deforestation.

For decades, palm oil has been criticized for its links to corruption, social injustice, and deforestation (Colchester et al., 2006).<sup>xx</sup> In SE Asia, government officials often awarded oil palm growers legal rights to clear forests in exchange for bribes. Officials generally did not consider the customary rights of the people living within affected areas.

Companies exploit confusing and contradictory landownership regulations. To make way for plantations, companies often force Indigenous Peoples and others off their land. They sometimes use slave and child labor (Skinner, 2013).<sup>xxi</sup> In 2012, 59 percent of the Indonesia's 1,000 palm oil companies were linked to land conflicts with local communities (Hadinaryanto, 2014).<sup>xxii</sup> Forest clearing for palm oil, including in peatlands, has pushed Bornean orangutans and Sumatran elephants and tigers to the brink of extinction, it has emitted hundreds of millions of tons of carbon pollution into the atmosphere.

To the extent the industry paid attention to concerns about deforestation or the exploitation of vulnerable communities, it responded with mostly cosmetic measures (Voices for Biodiversity, 2013).<sup>xxiii</sup> Occasionally some companies did the right thing. But mostly, business as usual moved plenty of money into the pockets of well-placed palm oil executives, bankers and corrupt officials. Governments promoted or tolerated this "collateral damage" in the name of economic development. Yet - contrary to public opinion - in Indonesia the entire plantation sector contributes only 2 percent of gross domestic product, despite public subsidies.

As a result, currently in Indonesia, 6.1 million ha are “stranded land” on the balance sheet of palm oil estates. This is slightly less than the size of the Republic of Ireland.

Stranded land are stranded assets. Stranded assets are “assets that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities” (Caldecott, Dericks, & Mitchell, 2015).<sup>xxiv</sup>

This magnitude of stranded assets is unknown to financiers. Analysts do not price these stranded assets into current financial valuations. 29 percent of Indonesia’s palm oil concessions cannot be developed without violating buyers’ No Deforestation, No Peat, No Exploitation (NDPE) policies. 95 identified palm oil companies each include at least 1,000 ha of stranded land. With 10 percent of Indonesia’s total land for palm oil concessions in the last 25 years, stranded land is material economic concern.

Traders and refiners – including Cargill, Bunge, and others – have suspended or excluded non-compliant growers from their supply chains because they are violating their NDPE policies. Recent examples include some of the largest palm oil companies globally: IOI Corporation, Austindo Nusantara Jaya, Sawit Sumbermas Sarana and Provident Agro.

Change is occurring as markets are beginning to understand the economic drivers of deforestation. As of 2014, 71 percent (Lawson, 2014)<sup>xxv</sup> of global forest destruction was driven by agriculture – primarily timber, cattle, palm oil and soy with mining and infrastructure development also playing significant roles (Lawson, 2014).<sup>xxvi</sup> These economic drivers of deforestation are closely related. Roads to access mines or dams in remote areas open protected forests to deforestation. Soy expansion in South America pushes out cattle farmers who seek new pastures. When improved law enforcement in Brazil limited deforestation, activities shifted to Peru and Paraguay (Graesser, Aide, Grau, & Ramankutty, 2015).<sup>xxvii</sup>

From 1990s to the 2000s deforestation of tropical forest to monoculture plantations dramatically increased in the Brazilian Amazon for soy, and in Indonesia and Malaysia for palm oil. Consequently, Brazil, and Indonesia and Malaysia became the target of advocacy campaigns.

Brazil then embarked on reforms in the soy and cattle sectors. These included the creation of multi-stakeholder processes, temporary moratoria, monitoring and mapping programs and creating a rural land registry. Brazil's rate of deforestation then began to decline steadily.

Since 2014, the Indonesian and Malaysian palm oil sector has seen 365 buyers make NDPE and zero-deforestation commitments. This has occurred largely in response to advocacy campaigns exposing deforestation and social conflicts. These buyers' NDPE policies have resulted in material financial risk to growers who do not adhere to their buyers' NDPE procurement policies. Environmental degradation and social conflict now have a material pricing signal observed in financial markets.

To mitigate these material financial risks, companies have invested in legal chain-of-custody certification mechanism called the Roundtable on Sustainable Palm Oil (RSPO) to maintain their access to markets and to demonstrate they are in compliance with their buyers' NDPE policies. RSPO now covers 17 percent of the global palm oil market. At 12.15 million metric tons, demand for RSPO products has provided an innovative market signal enabling corporations to execute upon their NDPE and zero-deforestation policies in a transparent time-bound manner.

Since 2014, more than 365 corporations have made zero-deforestation palm oil commitments (often called "NDPE" policies). As Paul Polman, chief executive officer of Unilever, has said: "It only takes a handful of sizable companies to reach a tipping point and to transform markets" (Center for Global Development, 2013).<sup>xxviii</sup>

For example, social pressure in 2016 pushed the Swedish corporation AAK to integrate a NDPE policy when it acquired California Oils September 5, 2016. California Oils is one of the major U.S. suppliers of palm oil. California Oils is now implementing AAK's NDPE policy. In 2015, California Oils imported 9.6 percent (110,000 metric tons) U.S. palm oil imports. California Oils and Toyo Suisan, Nissin, Sanyo Foods and Nongshim account for 84 percent of the U.S. instant noodle market. Together, they own 22 percent of the global instant noodles market. Instant noodles are generally 50 percent by weight palm oil (Thoumicfa, 2016j).<sup>xxix</sup>

Analysis of bank financing 2006–2015 of 16 SE Asian palm oil companies clearly demonstrates that banks are key palm oil financiers. Underwriting is dominated by U.S. and Malaysian banks. In fact, most banks surveyed have weak to no ESG policy relevant to the material financial risks in the palm oil sector. But generally, from 2010-2015, those SE Asian palm oil companies that received more loans and issued more bonds had improved their sustainability performance (Chain Reaction Research 2017).<sup>xxx</sup>

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