# Commodity Market Intelligence Update No. 4

## Palm Oil and the Financial Sector

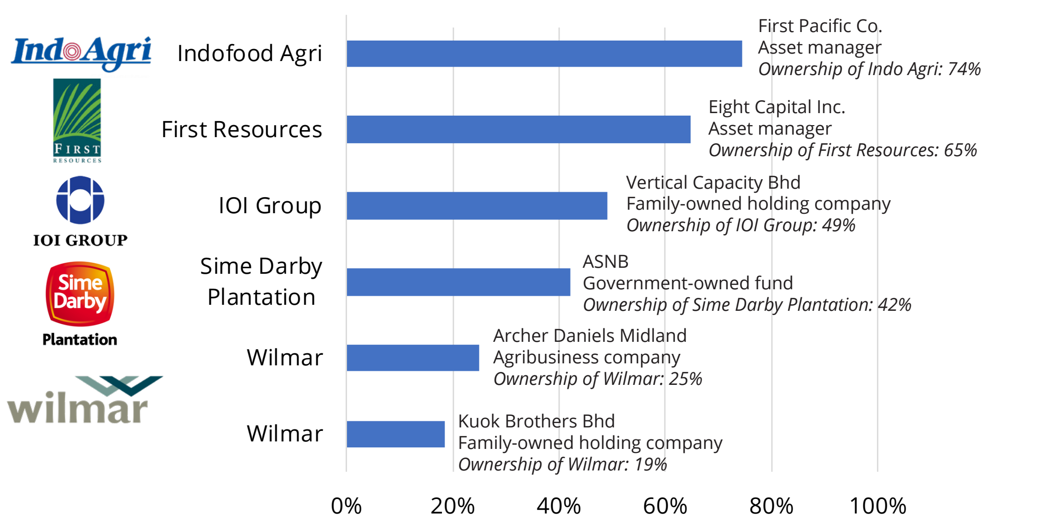
Parties at the December 2018 United Nations Climate Change Conference (COP24) in Poland continued to elevate the importance of addressing climate change through more sustainable agriculture, forestry, and other land uses. With deforestation and other types of land-use change associated with agricultural production contributing nearly a quarter of the world's greenhouse gas emissions and causing significant biodiversity loss, banks and investors which finance agribusiness and companies that are large buyers of agricultural commodities, including palm oil, are inextricably linked to the environmental impacts of production. Some banks and investors are starting to address these concerns, in part through a range of tools and initiatives that are increasingly available to engage the financial sector.

Rising global demand for oil palm, a high-yielding and widely consumed vegetable oil crop grown only in the tropics, is driving deforestation in some of the world's most biodiverse ecosystems, including the vast rainforests and peatlands of Southeast Asia. In addition to providing habitats for several endangered and endemic species, these biomes serve as carbon sinks, helping to mitigate the effects of climate change. In the major palm oil producing regions of Sarawak, Sabah, Kalimantan, and Papua in Malaysia and Indonesia, 40-60% (2.5 million hectares) of all oil palm plantation area originated in forests cleared for agriculture between 1990 and 2010, with an additional area three times this size (7.8 million hectares) cleared for various uses, including oil palm, from 2011-2017. In total, oil palm plantations cover 17 million hectares of land in Malaysia and Indonesia, over a quarter of their combined agricultural land. 3.8 million hectares of this area is managed by the 20 largest palm oil companies. Land clearing, often for oil palm cultivation, accounts for 80% of carbon emissions in Indonesia, the largest palm oil producing country. With demand for palm oil expected to double by 2030, including for use in biofuels and foods, financing of the commodity has an important role to play both in providing food security and keeping global temperature increases below 1.5 degrees Celsius.

Each year, investors purchase millions of dollars of stocks and bonds issued by major palm oil companies, helping them finance new facilities, acquire companies, and bring new land into production. Diverse investor groups, ranging from asset-management companies, founding families, government-owned funds, and even other agribusiness companies hold sizeable ownership stakes in some of the most important palm oil producers (see Figure 1). Large investors are influential in company operations, and are often afforded voting power on important issues such as board composition and the integration of Environmental, Social, and Governance (ESG) policies, including how companies produce and source palm oil.

Figure 1: Large Investors in Select Palm Oil Companies
Percent Ownership of Company's Stock

Various types of investors have anywhere from 20%-75% ownership stakes in select major palm oil companies.




Source: *Bloomberg.* Note: Vertical Capacity Bhd is owned by Malaysia's Lee Shin Chen family. Amanah Saham Nasional Berhad (ASNB) is a Malaysian government-owned investment body. Malaysia's Employee Provident Fund (KWSP) owns an additional 14% of Sime Darby Plantation. ASNB and KWSP also hold a 48% combined ownership stake in Maybank, Malaysia's largest bank.

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Banks directly lending to palm oil companies and smallholder growers are also key in financing new development (see Figure 2). At least $5 billion in capital is typically required to convert one million hectares of land into a producing oil palm estate. A potential 60 million tons of additional annual palm oil demand by 2030 could require 18 million hectares of new land at current yields, an area larger than all current oil palm production area in Indonesia and Malaysia. Recognizing the role sustainable agriculture can play in reducing emissions, some banks have begun to act. Singaporean banks DBS Bank, OCBC, and UOB, are requiring agribusiness clients to have policies protecting high conservation value areas. From new borrowers in the palm oil sector, DBS Bank requires alignment with even stronger No Deforestation, No Peat, No Exploitation (NDPE) policies. European banks HSBC and BNP Paribas require client membership in the Roundtable for Sustainable Palm Oil (RSPO), a standard recently strengthened to stop the deforestation of high carbon stock landscapes.

Figure 2: Select Loans to Palm Oil Producers

This table shows banks with current significant loans to companies involved in palm oil supply chains, indicating if the lending bank has a palm oil policy, and whether the bank or loan recipient are members of the RSPO or other relevant fora for engaging in sustainable commodities finance.

| Bank | Palm Oil Policy/RSPO Member? | Forum Membership | Loan Recipient | Loan Amount and Maturity | Role in Supply Chain | RSPO Member? |
|---|---|---|---|---|---|---|
| ANZ (Australia) | Yes/Yes | UNEP-FI RSPO | Louis Dreyfus CO. Asia | $600 million 2021 | Palm Oil Processor and Trader | Yes |
| Bank Negara (Indonesia) | Yes/No | UNEP-FI ISFI | Eagle High Plantations | $90 million 2020 | Oil Palm Grower | Yes |
| Bank Rakyat (Indonesia) | Yes/No | ISFI | Perkebunan Nusantara VIII | $88 million 2022 | Oil Palm Grower, Palm Oil Processor | Yes |
| BNP Paribas (France) | Yes/Yes | UNEP-FI, PRB, SCC, RSPO | Olam | $500 million 2021 | Oil Palm Grower, Palm Oil Processor and Trader | Yes |

Source: *Bloomberg*. Note: UNEP-FI is the United Nations Environment Programme-Finance Initiative, PRB is UNEP-FI's Principles for Responsible Banking, SCC is the Soft Commodities Compact. ISFI is the Indonesia Sustainable Finance Initiative.

Asian regional banks, primarily those based in the same countries where many oil palm growers and manufacturers operate, are particularly influential in palm oil lending. Though the scale of financing varies, each regional bank shown below (Figure 3) engages in lending to palm oil companies. Broad buy-in on ESG issues from these banks, including the financing of high-carbon sectors, can be especially impactful in advancing the sustainability of the palm oil industry. Through strong policies, processes, and governance frameworks, Asian banks funding the majority of palm oil production can help the industry meet future demand while also contributing to international climate goals.

Figure 3: Largest Regional Banks in Indonesia, Malaysia, and Singapore by Market Capitalization

Asian regional banks, which generate anywhere from 65-95% of their revenues from their home countries, have been identified as the most common sources of palm oil lending. Market capitalization is the value of all outstanding company shares and gives an indication of the size and local importance of each bank.

| Indonesia | Malaysia | Singapore |
|---|---|---|
| BCA<br>Bank Central Asia ($41 billion) | Maybank<br>Malayan Banking ($27 billion) | DBS<br>Development Bank of Singapore ($49 billion) |
| Bank Rakyat Indonesia ($29 billion) | CIMB BANK<br>CIMB Bank ($14 billion) | OCBC Bank<br>Oversea-Chinese Banking Corporation ($37 billion) |
| mandiri<br>Bank Mandiri ($24 billion) | RHB<br>RHB Bank ($5 billion) | UOB 大華銀行<br>United Overseas Bank ($35 billion) |

Source: *Bloomberg, October 2018.*

As awareness of the connection between agriculture, tropical deforestation and climate change grows, the financial sector is now seen as an integral part of commodity supply chains. At COP24, the Investor Agenda, representing nearly 415 investors with $32 trillion in assets, urged governments to implement actions to achieve the goals of the Paris Agreement. Numerous other banks and investors are also aligning with the Paris Agreement through platforms like Climate Action 100+ (310 investors), the Soft Commodities Compact (12 international banks), and the U.N.'s Principles on Responsible Banking (28 banks with $17 trillion in assets). 90 investors with ownership stakes in palm oil companies have signed an open letter advocating strong RSPO standards, and a group of 25 investors are engaging companies across the palm oil value chain on climate risks, including Asian regional banks. Investors managing $6 trillion in assets have joined as signatories supporting the Cerrado Manifesto, which calls for an end to agricultural driven land conversion in Brazil's Cerrado biome. Regionally-tailored sustainable sourcing platforms, like Support Asia for Sustainable Palm Oil, the China Sustainable Palm Oil Alliance, and the newly launched Sustainable Palm Oil Coalition for India are attracting food manufacturers and investors from key demand markets.

For financial institutions seeking to develop capacity in to implement deforestation-related policies and risk mitigation strategies, at least 11 interactive, customizable tools are available to help (see Figure 4). These tools range from geospatial systems like Trase and Global Forest Watch, which can be used to discover sourcing, land use, and biodiversity risks, to policy benchmarking tools like SCRIPT, which enable financial institutions to assess their own policies against industry peers and others in palm oil value chains. Banks and investors can use portfolio and reputational risk exposure tools to conduct due-diligence and view suggestions on how to limit exposure to deforestation and other environmental risks from financing commodity production. WWF and the investment group CLSA have also produced a sustainable palm oil primer, "Keep Palm... Edible-oil Sustainability in Asia", providing an overview of palm oil sustainability issues and offering guidance for banks and investors to engage their clients on environmental and social issues.

Figure 4: Tools for Banks and Investors

These tools provide capacity and guidance to banks and investors seeking to strengthen their ESG and deforestation-related policies. Most tools have capabilities across multiple areas.

| Tool Type | IBAT | SPOTT | Trase | GFW | GFW Pro | SCRIPT | MPP | SUSBA | GMAP | NEPcon | RSPO |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Reputational Risk Exposure | | | ✓ | ✓ | ✓ | ✓ | ✓ | | ✓ | ✓ | ✓ |
| Geospatial | ✓ | | ✓ | ✓ | ✓ | | ✓ | | ✓ | | |
| Portfolio Exposure | | ✓ | ✓ | | ✓ | ✓ | | | | ✓ | |
| Policy Benchmarking | | ✓ | | | | ✓ | | ✓ | | | |

Note: IBAT: Integrated Biodiversity Assessment Tool; SPOTT: Sustainability Policy Transparency Toolkit; GFW: Global Forest Watch; SCRIPT: Soft Commodities Risk Platform; MPP: The Forest Trust's Mill Prioritization Process; SUSBA: Sustainable Banking Assessment; GMAP: Global Map of Environmental and Social Risks in Agro-Commodity Production; NEPcon: Nature Economy and People Connected; RSPO: Roundtable for Sustainable Palm Oil Guide for Investors

As the combined value of stock exchanges in Singapore, Indonesia, and Malaysia tops $1.5 trillion and continues to grow, environmental and social risks are becoming greater determinants of valuation for publicly-traded companies. Issues like the Southeast Asia haze crisis, illegal deforestation, and labor abuses have the potential to quickly materialize into reputational and monetary risks for companies involved in palm oil supply chains. The prospect of severed business relationships and negative public perceptions, in addition to losses in market value on stock exchanges, means palm oil growers, manufacturers, and financers alike are incentivized to mitigate these risks. The financial sector and others in palm oil supply chains have the potential to contribute to both global climate goals and reducing agriculture's impact on valuable ecosystems, and have abundant resources at their disposal to take steps in this direction.

## **Key Companies Update** (all commodities)

China's state-owned agribusiness giant COFCO is continuing to expand its presence in Latin American soy. As part of its plans to double the volume of soybeans it sources from Mato Grosso, Brazil's largest soybean producing state, COFCO has begun construction of a 60,000-ton capacity silo in the north of the state that will help supply exports to China. COFCO has 22 grain silos in Brazil, 14 in Argentina, and 7 in Paraguay, with a total capacity of 2.7 million metric tons. COFCO exported 5.5 million tons of soybeans from Brazil in 2017, close to 10% of the country's total soy exports and a 14% increase from the previous year. Nearly 2 million tons of these exports were sourced from Brazil's Cerrado ecosystem, according to Trase data. COFCO's growth has also been propelled by the purchase of Singapore's Noble Agri in 2016 and the Netherlands' Nidera in 2017, which allowed the company to acquire agribusiness infrastructure in key Latin American countries.

Separately, China's Feed Industry Association has approved lower protein-content formulas for pork and poultry feed in an effort to cut China's annual soybean consumption by 14 million tons per year. China imported 90 million metric tons of soybeans in 2018, largely to supply its growing animal feed industry. Prolonged trade tensions with the U.S. are causing China to re-strategize imports of the key feed ingredient, including sourcing a greater share of its soybean imports from Brazil.

Myanmar has emerged as a growing consumer of palm oil, partially driven by the country's fast-food expansion. Global food retailer Yum! Brands has opened 21 KFC locations in the country (with 12 more expected by mid-2019) and has partnered with conglomerate Jardine Matheson to open Pizza Hut locations. Though growing, Yum! Brands' footprint in Myanmar is still dwarfed by the company's presence in China, Indonesia, and Malaysia, where it operates close to 10,000 locations. Yum! Brands is an RSPO member, and gives preference to RSPO-certified suppliers for its restaurants which use palm oil. Other fast food chains using palm cooking oil, like Malaysian fried chicken restaurant chain Marrybrown and Korea's Lotteria Burger (operated by Korean conglomerate Lotte Group) have also been expanding in Myanmar.

Myanmar is a small producer of palm oil, with 140,000 hectares planted with oil palm at last count, and an additional 400,000 hectares allotted for development. Insufficient domestic production has led imports of palm oil to grow more than three-fold since 2008, making Myanmar the 12th largest palm oil importing country. To capitalize on rising demand, Malaysia's Felda Global Ventures (FGV) is planning to build palm oil refineries in Myanmar to process growing imports from nearby Indonesia and Malaysia. Palm oil is commonly used as a cooking oil in both households and food retail throughout Asia.

Rising global demand for meat is shifting how large commodity traders do business. While Argentina's drought and international trade frictions have restored some profits to the grain trading business, both Cargill and Archer Daniels Midland (ADM) are making concerted efforts to diversify from traditional grain trading to value-added feeds and animal proteins. Cargill posted record profits in fiscal year 2018, largely driven by these business segments.

Cargill recently acquired American and Brazilian feed producers Diamond V and Integral, and formed new poultry businesses in Colombia, the U.K., the Philippines, and Poland. The company also opened a shrimp-feed plant in Ecuador that it estimates will produce 165,000 tons of feed per year, and a poultry and pig feed plant in Vietnam that will produce 240,000 tons of feed annually. In July 2018, ADM purchased French feed producer Neovia for $1.8 billion, which sells most of its animal feed in Asia and Latin America. ADM also acquired Ecuadorian shrimp feed producer Balnova in September and Colombian poultry feed producer Biomix in December, both of which were purchased through Neovia.

The prominent role of soy in the production of animal feed will continue to drive the footprint of large agribusiness companies operating in Latin America. Bunge, Cargill, COFCO, Louis Dreyfus, and Marubeni, who are each involved in the production of animal feed, shipped 55% of Brazil's soy exports in 2017. Louis Dreyfus and Cargill are the only major soy traders to have sustainability policies covering the Cerrado ecosystem, a biodiverse savannah located predominately in the Northeastern states of Maranhão, Tocantins, Piauí, and Bahia covering 9% of Brazil's land area.