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Deforestation and the challenges it poses for companies

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Deforestation is not a new issue. However, recent environmental disasters such as Indonesia's forest fires in the summer of 2015 have reignited public interest in the subject. While the net rate of annual forest loss has slowed, 10 million hectares of tropical forests alone are still destroyed annually, an area of the size of South Korea.¹ Deforestation accounts for around 12% of man-made greenhouse gas (GHG) emissions globally, roughly equivalent to the GHG emissions from the transport sector.² It is also linked to other issues including land grabs, community displacement and food security. Net forest loss is highest in the low-income group of countries and associated with increasingly rural populations.³

The implication for companies

Almost 80% of deforestation is linked to agriculture, with the four big forest commodities, cattle products, palm oil, timber products and soy, accounting for almost a third of global deforestation.⁴ While responsibility for tackling deforestation has traditionally been placed on upstream producers, processors and traders, as well as small-scale farmers and local authorities, downstream manufacturers and retailers that rely on forest commodities in their supply chains also have a role to play. There has been increasing scrutiny on multinational companies. Several reports, including the CDP Global Forests Report and Supply Change Forest Trends Reports, track large multinational companies' commitments and actions.

Investors can be exposed to reputational or financial risk either from investing directly into producers or through investee companies' supply chains. When IOI Group, a Malaysian palm oil company, was suspended from the

Roundtable on Sustainable Palm Oil (RSPO) for violating its policy on clearing forests in March 2016, its shares fell 18%. Forestry or agriculture assets could experience an unanticipated or premature writedown, devaluation or conversion to liability as a result of a variety of risks.⁵

The reputational risk faced by companies that fail to address deforestation in their supply chain is also high. Criticism and campaigns can lead to consumer boycotts, and can even result in companies being denied finance. There are also operational risks. Twenty-six large corporates decided to suspend their contracts with IOI following its RSPO suspension, including Unilever, Nestle, Mars, Johnson & Johnson and Procter & Gamble. But switching suppliers may be costly and difficult to implement. Only 20% of palm oil is currently RSPO certified, and for timber only 11% of the global forest area is covered by a timber certification, such as the Forest Stewardship Council.⁶



The ratification of the Paris Agreement and the United Nation's Sustainable Development Goals are also supporting further initiatives and potential regulation on deforestation to mitigate climate change. The French government, for example, attempted to include a tax on Indonesian palm oil in its biodiversity law passed recently. While the so-called "Nutella tax" was watered down in the final draft of the law, it demonstrates the risk of further regulation.

What companies can do to address deforestation

Companies have made a lot of progress introducing commitments, especially around palm oil and timber. Seventy percent of the companies that responded to the CDP forest questionnaire have a commitment to reduce or remove deforestation and forest degradation, many of them looking to the year 2020 to achieve a level of raw material certification.⁷

The attention companies give to different commodities also varies. For instance, cattle products cause approximately 2.7 million hectares of annual tropical forest loss alone, 10 times more than palm oil, yet only 15% of those with exposure to cattle-driven deforestation have made a commitment to address this.⁸ But companies often struggle to implement these commitments. The lack of transparency makes traceability in the supply chain difficult. In addition, any costs of changing to certified raw materials have to be leveraged elsewhere in the company or passed onto consumers. This can act as a barrier, especially for smaller companies.

Multi-stakeholder groups such as the RSPO for palm oil, the Forest Stewardship Council (FSC) for timber, and the Rainforest Alliance, are key to helping improve sourcing standards. Their certification programmes allow companies to better track where their raw materials come from. However, certifications are standardised and will not fit all companies equally well. They

are a good basis but should be supplemented by additional commitments. In addition, some certifications have been subject to criticism. An interesting development is that of jurisdictional certification schemes, where local governments make a commitment to produce only certified commodities in their jurisdiction. This system, which relies on local monitoring, is better at addressing region-specific issues such as community displacement. It is currently being trialled in several countries including Malaysia, Indonesia and Brazil.

by Katharina Lindmeier

How our investee companies are addressing deforestation

Bellway is a major UK housebuilder with a well-established and highly regarded management team. As one of the UK's largest housebuilders, Bellway plays an important role in addressing the growing national housing shortage while delivering returns to shareholders in a way that protects and enhances the environment and the economy. Industry fundamentals are currently favourable for the housebuilding sector, supported by a benign land market and continual undersupply of good-quality homes.

Through its chain of custody, Bellway ensures that timber from the forest to the final point of purchase is certified. Bellway will aim to ensure that all wood products used by the company in its housebuilding process originate from verified, well-managed forests.

The cornerstone of Bellway's policy means the timber used to build a house is sourced from managed stewardship forests accredited to PEFC (programme for the endorsement of Forest Certification) or FSC. This allows Bellway to have high levels of transparency and traceability to guarantee compliance for its timber supplies.

Bellway has a robust approach for its supply chain management, which enables it to develop long-term relationships with its suppliers.

Procurement is controlled using a centralised approach selecting suppliers, products and services that meet the quality and value-for-money requirements of the business, while at the same time minimising any negative social and environmental impacts. Bellway's wood procurement policy is communicated to all its timber suppliers. The company has to balance many different stakeholders when it constructs a new home, but still has managed to deliver impressive financial returns, growing its profits before tax from £246 million to £354.2 million over 2014 to 2015 (source: Bellway 2016).

Mondi is an international integrated paper and packaging company that has exposure across the whole value chain, from managing forests and producing pulp, paper and compound plastics to developing effective and innovative industrial and consumer packaging solutions.

The paper and packaging industry faces many global challenges around ongoing climate change, biodiversity loss, deforestation and degradation of land, as well as freshwater ecosystems and resource scarcity. These global megatrends and international collective action are increasingly calling for Mondi to drive sustainability and transparency across its business.

Wood is one of Mondi's most important raw materials. The company's challenge is to meet the increasing demand for paper and packaging products, while still adhering to its sustainable forestry policy. Mondi's sustainable forestry policies considers the productive capability, biological integrity and community needs of the forests that it owns, manages and sources material from.

There is increasing demand from Mondi's customers for sustainable fibre usage. In order to address this, Mondi has a policy of 100% FSC certification and promotes sustainable management of its owned and leased forests. From forests Mondi does not own, there is a minimum of 70% FSC certification.

In collaboration with its suppliers, Mondi is taking steps to encourage greater transparency and promote fair working conditions by developing a responsible, inclusive and sustainable supply chain.

Mondi has developed a successful global partnership with the World Wildlife Fund. This partnership is enabling shared learning and collaborative action to promote ecosystems, manufacturing and product stewardship. Projects in Russia in the Boreal and Silver Taiga have explored effective ways of balancing increased commercial yields while protecting high conservation value areas and benefiting the local communities.

Despite these many challenges, Mondi delivered profit growth of 24% in 2015. The key driver of Mondi's profit growth in 2015 was attributable to the return from self-help capex initiatives. Many of these initiatives and much of the return is directly attributable to lowering energy requirements and gaining green energy credits.

As an investment, Mondi is on top of these issues and Standard Life Investments is reassured that the company is not linked to any illegal deforestation and does not use illegal wood in its production process.

by Lesley Duncan

¹ World Resources institute Blog <http://www.wri.org/blog/2015/09/satellites-uncover-5-surprising-hotspots-tree-cover-loss>)

² IPCC WG2, 2014

³ Food and Agriculture Organisation of the United Nations, State of the World's Forests 2016

⁴ Supply Change, Supply Change: Tracking Corporate Commitments to Deforestation-free Supply Chains 2016

⁵ Kepler Cheuvreux, Forest & land degradation 360 report

⁶ UNECE Forest Products Annual Market Review 2014-2015

⁷ CDP Global Forests report 2015 <https://www.cdp.net/en/research/global-reports/global-forests-report-2015>

⁸ Supply Change, Supply Change: Tracking Corporate Commitments to Deforestation-free Supply Chains 2016

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