

# ESG Materiality Newsletter

Q1 2021

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**Federated  
Hermes**   
International

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# Introduction

## Responsible investing in practice

Over the past decade, we have sought to act as responsible investors in emerging markets by focusing on companies that can tackle sustainability challenges as they arise. To explore our vision for responsible long-term investing in emerging-market equities, please [read our commentary](#).

In our ESG Materiality Newsletter, Q1 2021, we seek to demonstrate our engagement activity with portfolio companies and showcase holdings that create positive impact aligned to the Sustainable Development Goals (SDGs). We also explore an environmental, social and governance (ESG) theme and its implications for the asset class.

## Engagement overview

Engagement is a key part of our process. We believe it helps us gain a deeper insight into companies' past and future opportunities and it can contribute to unlocking shareholder value and/or limiting downside risks. We engage alongside our colleagues at EOS at Federated Hermes ('EOS'), who are leading experts in stewardship and advocacy. Our engagement approach is systematic and transparent. To measure our progress and the achievement of engagement objectives, we use a four-stage milestone strategy.

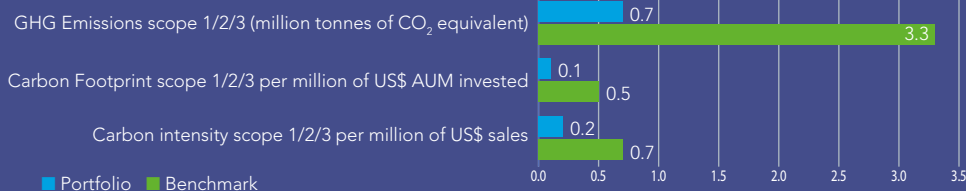
When we set an objective at the start of an engagement programme with a portfolio company, we will also identify recognisable milestones that need to be achieved. Progress against these objectives is assessed regularly and evaluated against the original engagement proposal.



## Our portfolio's carbon footprint, Q4 2020

Our portfolio is considerably greener than the MSCI emerging-market benchmark in terms of scope 1, scope 2 and scope 3 greenhouse gas (GHG) emissions.<sup>1</sup>

### Federated Hermes EM equity fund vs MSCI EM benchmark



Source: Federated Hermes, as at 31 December 2020. The benchmark is the MSCI Emerging Markets Index.

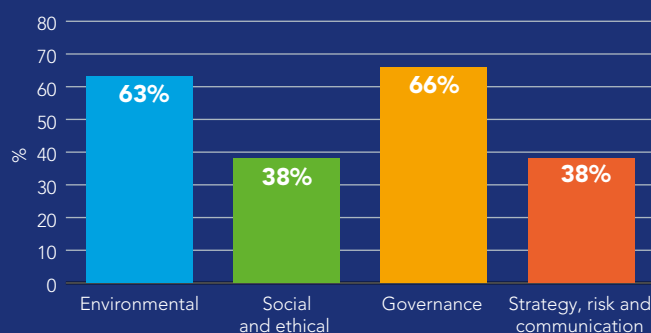
## Engagement highlights, Q4 2020

As of the end of December 2020, we engaged:

# 83%

of our holdings in terms of AUM

### % of AUM engaged by theme



Source: Federated Hermes, as at 31 December 2020.

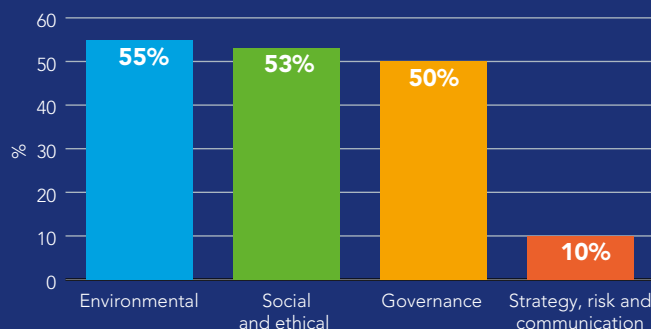
## Engagement progress over the last 12 months

Actual: 42%

Internal target: 40%

Source: Federated Hermes, as at 31 December 2020.

## Engagement progress by theme



Source: Federated Hermes, as at 31 December 2020.

<sup>1</sup>We adopt the methodology set by the Task Force on Climate-related Financial Disclosures (TCFD) to measure our portfolio's emissions, carbon footprint and emission intensity. See *Implementing the recommendations of the Task Force on Climate-related Financial Disclosures* for further information.



## ENGAGEMENT CASE STUDY

# Baozun Inc.

**Shanghai-based Baozun is a leading Chinese provider of e-commerce technology and solutions. It is often referred to as “the Shopify of China” since both companies help retailers sell their products online via various e-commerce platforms (although there are some differences in their approach<sup>2</sup>).**

### Engagement theme

- Environmental: packaging and logistics
- Governance: disclosure, accounting, Nasdaq listing, Variable Interest Entity (VIE) and related party transactions
- Social: ban on imports from Xinjiang due to human rights concerns, data protection



Baozun provides ex-China multinationals with a relatively quick and cost-effective “one-stop solution” to accessing China's thriving online-retail market.

Its clients include iconic Western brands such as Nike, Microsoft and Starbucks. It offers these companies services such as digital store setup, customised online stores, order fulfilment, logistics and customer service. Baozun is able to provide seamless omni-channel services covering not only official brand websites and stores on marketplaces such as Alibaba's Tmall and JD.com, but also emerging channels. These include mobile (for example WeChat Stores) and online to offline (O2O) – using a digital environment to encourage purchases from physical businesses.

### Measuring and reducing carbon footprint

As more and more Chinese consumers buy online, the environmental impact of packaging and delivery is a key issue. During our Q4 2020 video call with management we encouraged Baozun to consider how the volume of packaging and the pollution caused by delivery systems affects the planet. The company confirmed that it uses electric vehicles (EVs) in its warehouses and encourages its logistics partners to use electric fleets to deliver goods to buyers (EVs have been incentivised in China for years). We encouraged the company to monitor and disclose the percentage of recycled material in its packaging and the percentage of EVs in its delivery fleet, as well as considering optimising routes to reduce congestion. Baozun highlighted its efforts in terms of using ships-in-own-container (SIOC) packaging. This saves resources both by reducing the unnecessary use of packaging materials and by bringing down the weight of goods transported. We believe it is a good example of a sustainable strategy that supports not only the planet but also the bottom line. We believe the company could take things even further by playing a role in collecting and disposing of goods at the end of their life, for example collecting defunct electronic goods at the time of delivery of a new phone or appliance (ideally for a fee).

### Governance structure, disclosure and accounting

In Q4 2020 we encouraged the company to improve its environmental, social and governance (ESG) disclosure. Baozun indicated that it intends to publish its first sustainability report in H1 2021: we will get back in touch with them in Q1 2021 to check progress on this. We believe improved disclosure is important given that the company is affected by several ESG issues which grab media attention, and the market could reward greater clarity. One of these issues from a governance perspective is the potential delisting of American Depositary Receipts (ADRs)<sup>3</sup> from US exchanges if Chinese auditors fail to pass their notes to their counterparts in the US. We are hopeful that China-US negotiations will lead to a solution which increases accounting transparency and avoids the delisting of ADRs from US markets. However, we are pleased that Baozun has mitigated this risk with its recent secondary share offering on the Stock Exchange of Hong Kong, even if this caused some dilution.



**Baozun highlighted its efforts in terms of using ships-in-own-container (SIOC) packaging.**

<sup>2</sup>Baozun is an “end-to-end” e-commerce solution that helps merchants at every step, whereas Shopify merely provides the cloud-based tools for merchants to run their own online businesses and does not involve itself in inventories or shipping. Baozun mainly serves large retailers who want to establish an ecommerce presence in China without hiring their own local teams. As such, its business is more capital-intensive than Shopify's.

<sup>3</sup>An American depositary receipt (ADR) is a negotiable certificate issued by a U.S. depository bank representing a specified number of shares—often one share—of a foreign company's stock. The ADR trades on U.S. stock markets as any domestic shares would.

Another issue we are paying close attention to is the company's overall governance structure and media reports at the country level regarding how this could be affected. Like other Chinese internet companies listed abroad, Baozun has a Variable Interest Entity (VIE)<sup>4</sup> legal structure in place. This means that Baozun's shareholders do not have control over the Chinese operating assets (VIEs are a necessary evil to allow foreigners to invest in internet companies in China today). In addition to that, investors need to be vigilant regarding Related Party Transactions (RPTs), since Baozun does a large percentage of its business with one of its largest shareholders, Alibaba, and its subsidiaries. It is worth noting that the Chinese regulator is critical of the role of internet giants and wants to encourage more competition via anti-trust investigations and recommendations. Baozun has been growing its relationship with other channels (for example Tencent's mini programs) and the percentage of gross merchandise value (GMV) sold via Alibaba's platforms is in decline.<sup>5</sup> We encouraged management to elaborate on its diversification strategy whilst ensuring that the group continues to exploit growth opportunities across all channels as they arise.

**The US recently banned imports of cotton, yarn and other goods from producers in the Xinjiang region in China due to human rights concerns.**



**We questioned Baozun about any potential repercussions for its business and its clients, since roughly 20% of the cotton consumed globally is produced in Xinjiang.**

### The value chain: from cotton fields to cyberspace

Approximately 50% of Baozun's GMV comes from apparel, much of which is produced using cotton. The US recently banned imports of cotton, yarn and other goods from producers in the Xinjiang region in China due to human rights concerns. We questioned Baozun about any potential repercussions for its business and its clients, since roughly 20% of the cotton consumed globally is produced in Xinjiang. It is important to stress that Baozun focuses only on e-commerce, logistics and customer service and has no involvement whatsoever in the procurement and manufacturing activities of its clients. However, we are reassured to note that large clients like Nike have confronted their suppliers in Xinjiang to stop recruiting new employees from the region.<sup>6</sup> Indeed, according to The United Nations Guiding Principles on Business and Human Rights (UNGPs), businesses should use their leverage over their clients or suppliers to address human rights violations even when they have not directly contributed to them.

At the other end of the value chain, we welcome improvements in Baozun's approach to data security and in particular the handling of its customers' personal information. The company's data protection policy now has group-wide coverage and customers have the right to access, modify and/or delete their personal data. Baozun has obtained ISO 27001 certification for its information security system, which recognises that it conducts information security audits and employee training on data handling.

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<sup>4</sup>A variable interest entity (VIE) refers to a legal business structure in which an investor has a controlling interest despite not having a majority of voting rights.

<sup>5</sup>In M9 2020 72% of GMV came from Alibaba, down from 80% in 2019. Source: Investor relations call, 16/12/2020.

<sup>6</sup>As per Nike's statement, when reports of the situation in Xinjiang Uyghur Autonomous Region (XUAR) 'began to surface in 2019 Taekwang stopped hiring new employees from the XUAR to its Qingdao facility and an independent third-party audit confirmed there are no longer any employees from XUAR at the facility.' Source: <https://purpose.nike.com/statement-on-xinjiang>, accessed January 2021



## POSITIVE IMPACT CASE STUDY

## Tech Mahindra Ltd

**Headquartered in India, Tech Mahindra is a multinational company specialising in the provision of software and IT solutions for clients in the telecoms, manufacturing, financial services and logistics sectors.**

### Theory of Change

Tech Mahindra offers solutions which can be used by clients who want to save energy and reduce their GHG emissions, either by moving their data centres to the cloud or by providing their services remotely. The company also offers technology that can help clients measure their carbon footprint. Meanwhile, its product portfolio for smart cities is focused on making cities and human settlements sustainable and safe – for instance, by improving waste management.

### Environmental focus

Tech Mahindra is a leading global enabler of digital transformation, consulting and business reengineering services and solutions. It helps clients integrate platforms and make greater use of technology including the Internet of things (IoT), the cloud, artificial intelligence (AI), blockchain and 5G. During our recent call with management we discussed the significance of SDG-aligned revenue sources for the company. Tech Mahindra's Chief Sustainability Officer, Sandeep Chandna, highlighted that 12% of total sales can be linked to SDGs. These cover smart cities, solar energy, the virtualisation of services and moving clients' data centres to the cloud. The company sees these areas as opportunities for growth and wants to capitalise on its relevant expertise to expand its revenues further. It aims to act as an enabler for businesses as regulation, society and markets force them to pay more attention to sustainability issues.

To seize the opportunity Tech Mahindra is investing to expand its offering and it is walking the talk with its own commitment to the Paris accord.<sup>8</sup> The Mahindra Group stands out within Emerging Markets for this pledge, being one of the few Indian firms to have set science-based targets (SBTs) such as greenhouse gas reduction targets that are consistent with the two degrees cap. Tech Mahindra aims to cut its Scope 1 and 2 greenhouse gas emissions<sup>9</sup> by 22% by 2030 and 50% by 2050<sup>10</sup>, mainly by increasing its use of green energy (which makes up 18% of the mix consumed today).<sup>11</sup> For its capital allocation simulations and decisions, the company uses a fictional carbon price of US\$10 per tonne to price in the cost of ESG externalities in its scenarios – in India the tax on coal is currently only around US\$5 per tonne.<sup>12</sup>

### Alignment with UN SDGs:

The overall culture of the group is strongly aligned with various United Nations Sustainable Development Goals (SDGs)<sup>7</sup> including:



In terms of its SDG-aligned offering, Tech Mahindra's products and services are focused on making cities and other human settlements sustainable and safe. Solutions like Smart Street Light, Smart Waste Management Systems and Smart Meter can be managed remotely through a smart city portal known as UMACC. Smart Building Management solutions help in reducing the consumption of resources.

Tech Mahindra's renewable energy solutions are removing inefficiencies and enabling more reliable energy supply. Its Microgrid as a Solution enables easy access to sustainable energy for communities. Meanwhile, at a macro level its IoT-based Connected Solar Plants solution can link plants globally, helping to forecast production, monitor substations, analyse real-time data, and audit and report energy production. The plug-and-play device also sends timely alerts during critical events to help manage weather issues and limit accidents.

**In terms of its SDG-aligned offering, Tech Mahindra's products and services are focused on making cities and other human settlements sustainable and safe.**



<sup>7</sup> For a full list see Tech Mahindra's Integrated Report 2019-20. For completeness, we note that a subsidiary, Tech Mahindra Americas Inc, received a lawsuit for alleged discrimination against non-South Asian employees in its hiring, promoting and terminating decisions. However, the group strongly denies the allegations and is vigorously defending the said matter and believes itself to be strongly placed to emerge successful. Currently, there is a motion to dismiss the lawsuit pending before the court and we are awaiting a ruling on that motion. Source: Email from Tech Mahindra's investor relations team.

<sup>8</sup> Mahindra plans to spend INR63.4m on greening its facilities and INR2.6m on water resilience (a total of approximately US\$1m). Source: Tech Mahindra Integrated Report 2019-20, page 159.

<sup>9</sup> Under the Greenhouse Gas Protocol, Scope 1 covers direct emissions, while Scope 2 covers indirect emissions relating to electricity purchases.

<sup>10</sup> Targets relate to the divisions over which Tech Mahindra has 100% operational control, i.e. its Indian operations, which represent more than 75% of assets. We expect targets relating to cutting Scope 3 emissions (covering all non-electricity related emissions in a company's value chain) and reaching net zero to be announced in April 2021.

<sup>11</sup> Source: <https://www.techmahindra.com/en-in/sustainability/>

<sup>12</sup> The funds fictionally spent for carbon pricing are then allocated to climate-centric initiatives such as solar plants, sewage treatment plants, purchase power agreements (PPAs), and installing LEDs and other energy-efficient devices. It should be noted that in India there is a proposed increase in the carbon tax on coal from the current level of US\$ 5.47 per tonne to US\$ 16.09 per tonne. Source: Tech Mahindra's Integrated Report 2019-20, page 70.

The virtualisation of services and offering services remotely are structural trends among Tech Mahindra's clients. As a result of the Covid-19 pandemic these trends have taken root more strongly in our societies, with remote working now a part of day-to-day life for most of us, and call centres and online services more important than ever. Tech Mahindra offers companies a range of solutions to help with going digital, delivering considerable benefits to wider society in terms of reducing road congestion and pollution.

Tech Mahindra also works with clients who want to move to an outsourced, cloud-based solution for data storage. Outsourcing data to specialists has many benefits, not least in terms of environmental impact: better capacity utilisation and more efficient cooling systems save energy, making a cloud-based approach both more environmentally friendly and better for the bottom line.

**Tech Mahindra aims to adopt sustainability as a "way of life". This is reflected not just in sustainable business practices but in a spirit of collaboration which leverages the power of its technology.**

#### A company with a purpose

Tech Mahindra aims to adopt sustainability as a "way of life". This is reflected not just in sustainable business practices but in a spirit of collaboration which leverages the power of its technology. To this end, Tech Mahindra has created communities and platforms which connect stakeholders, in an effort to solve some of the most critical sustainability challenges the world is facing. GAiA, its ACUMOS-powered open source AI platform, democratises knowledge and make it accessible to everyone, accelerating change and encouraging the adoption of solutions which address business and environmental problems. For example, its "community of thinkers" (#AI4Action) leverages the company's AI-powered technology to facilitate knowledge sharing around tackling climate change.

These knowledge sharing initiatives are not the only action the company is taking on the social aspect of ESG. The Tech Mahindra Foundation (TMF) runs various corporate social responsibility (CSR) initiatives which aim to improve education for children and young people from marginalised sections of society.

**In terms of its SDG-aligned offering, Tech Mahindra's products and services are focused on making cities and other human settlements sustainable and safe.**

The company is also playing a part in providing care during the Covid-19 crisis by helping the Indian Government set up tele-health services. These use the mobile app AragyaSetu to connect Indian people with essential health services in the fight against the pandemic. Tech Mahindra has also developed a digital health kiosk and deployed over 50 "Health ATMs" across India and Africa to deliver health screening, live video-consultation with doctors, instant health reports and prescriptions, medicines, and help in managing and monitoring health.



**Tech Mahindra's renewable energy solutions are removing inefficiencies and enabling more reliable energy supply.**

## IN FOCUS:

# Can palm oil ever be considered sustainable?



### At a glance: The power of investors in the fight for sustainable palm oil

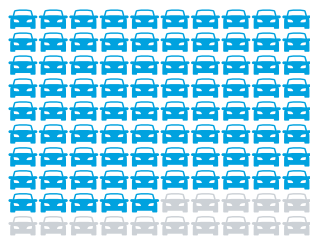
- Extensive monocropping for the production of palm oil is one of the main causes of deforestation.
- However, environmentalists argue that boycotting palm oil may have adverse environmental, social and economic repercussions.
- Responsible investors take the same view and prefer engagement over the exclusion of palm oil from investment portfolios, unless the production fails to meet strict sustainability criteria.
- Engagement and advocacy are needed to eradicate deforestation and exploitation.
- Actors along the value chain and responsible investor can encourage the adoption of globally recognised certification standards. They can also support smallholders with capital and expertise to increase their yields.
- While we have no exposure to growers and distributors in our portfolios, we have positions in food or cosmetic companies, local banks and supermarkets selling products that contain palm oil in various emerging markets.
- We are encouraged by the progress that our current holdings have made and we will continue to engage on material cases.

### If emissions from tropical deforestation were a country, it would rival the United States<sup>13</sup>

It is hard to overstate the importance of forests, both environmentally and otherwise.

Covering over 30% of the world's land mass<sup>14</sup>, forests supply food, medicine, building materials and fuel for more than a billion people. Worldwide, they provide more than 86m green

The loss of tropical trees is causing more emissions every year than



**85m**  
cars would over their entire lifetime

jobs and support the livelihoods of many more. In terms of biodiversity, forests are home to an estimated 80% of the world's plant and animal life<sup>15</sup>, including endangered species such as the orangutan, Borneo pygmy elephant and Sumatran rhino.

Forests are clearly a resource but, as history proves, they have also been used as large, undeveloped swaths of land that can be cleared and converted for other purposes.

According to the UN Food and Agriculture Organization (FAO), the rate of global deforestation has been decelerating over the past three decades<sup>16</sup>. Nevertheless, it continues to endanger local communities, contribute to global warming and result in the loss of biodiversity:

- Today, most deforestation is happening in the tropics where, thanks to newly constructed roads, previously inaccessible areas of forestland are now reachable. This is a concern, not only because tropical forests are one of the greatest biodiversity reservoirs on Earth, but because the World Economic Forum and Swiss Re estimate the value of biodiversity to exceed \$40tn, more than half of the world's GDP<sup>17</sup>. The 15th meeting of the Conference of the Parties (COP 15) to the Convention on Biological Diversity (CBD) – which is scheduled to take place this year in China – is expected to further emphasise the value of biodiversity and 'natural capital'.
- Fewer trees also mean a loss of cooling power and carbon capture, which has alarming consequences for global warming. **If tropical deforestation were a country, its annual impact would be comparable to the greenhouse gas emissions (GHG) of the United States, the world's second largest emitter.** Put differently, the loss of tropical trees is causing more emissions every year than **85m cars would over their entire lifetime.**<sup>18</sup>
- In addition to the environmental damages, the loss of tropical forests has dramatic social implications, depriving local communities of their homes and income. The process often goes hand-in-hand with worker exploitation, child labour and/or corruption.

<sup>13</sup> See World Resource Institute, citing Seymour & Busch 2016.

<sup>14</sup> According to the UN Food and Agriculture Organization (FAO) report, State of the World's Forests 2020 (July 2020), forests cover 31% of the global land area.

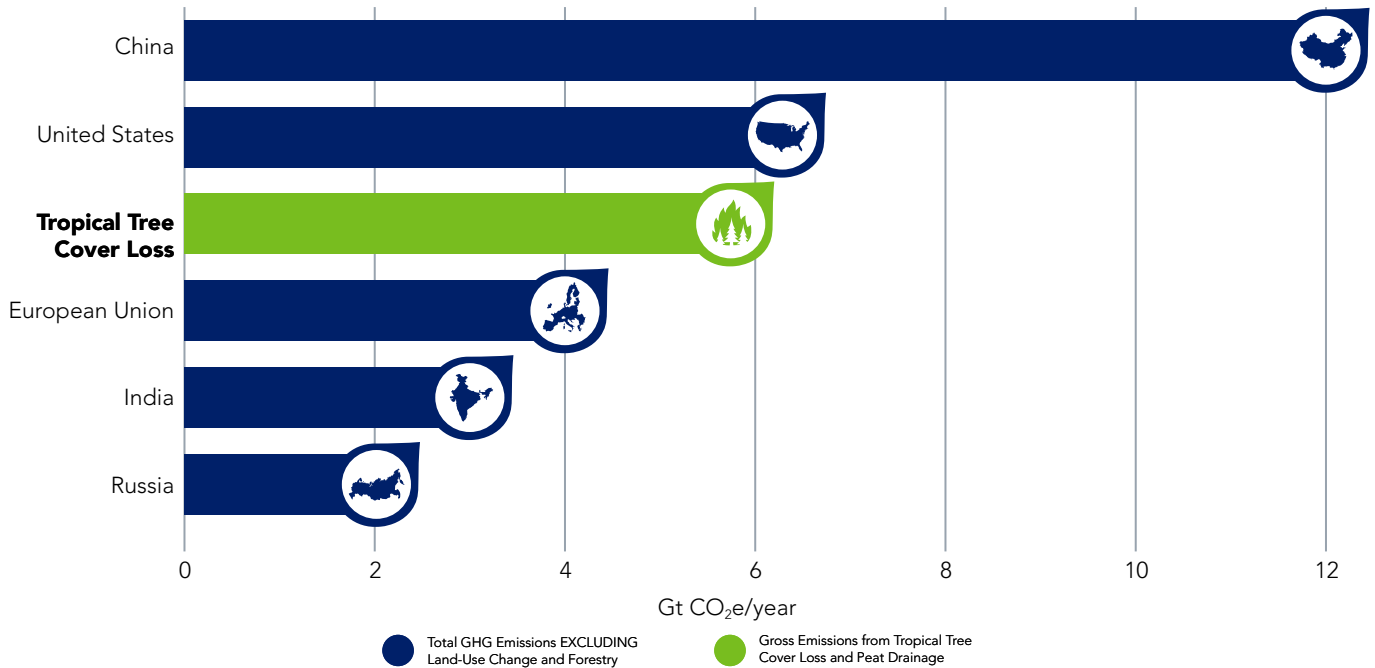
<sup>15</sup> As above.

<sup>16</sup> Between 2015 and 2020, the rate of deforestation was estimated at 10m hectares p.a., down from 16m hectares per year in the 1990s (regional differences apply; see the rate of deforestation in the Amazon rainforest has increased recently, after a long downward trend).

<sup>17</sup> Research from the World Economic Forum in collaboration with PwC "shows that \$44tn of economic value [...] is moderately or highly dependent on nature and its services and is therefore exposed to nature loss" (Jan 2020). According to Swiss Re, 55% of 2018 global GDP (or US\$41.7 trillion) depends on high-functioning Biodiversity and Ecosystem Services (BES) including such necessities as food provision, water security and regulation of air quality that are vital to maintaining the health and stability of communities and economies.

<sup>18</sup> See World Resource Institute, citing Seymour & Busch 2016. If we look at all type of forests, then the amount of carbon stored is nearly 300bn tonnes, which is roughly 40 times the annual greenhouse gas emissions from fossil fuels (see Greenpeace, Indonesian Forests and Palm Oil).

## If tropical deforestation were a country, it would rank third in CO<sub>2</sub>e emissions



Extensive monocropping for the production of palm oil is one of the main causes of deforestation, together with urbanisation, cattle ranching, soybean production and logging<sup>19</sup>.

### So, if palm oil causes deforestation, why can't we just stop using it?

At the heart of palm oil's success is its versatility. Palm oil is used in 70% of cosmetic products, yet most of us don't think about its origins when going about our morning routine with soap bars, toothpaste and face creams.

And it's not just cosmetics; palm oil is in around half of all supermarket products. It is a key ingredient in staple foods such as bread and margarine, as well as delicious treats like chocolate, ice cream, peanut butter, instant noodles, chocolate spreads and biscuits, where it is praised for its texture and taste. It can also be used in the production of biodiesel and biofuel for cars and power plants.

There are many reasons why palm oil is so popular. Firstly, palm trees produce 4-10 times more oil than other crops per unit of cultivated land and consume less water in the process<sup>20</sup>. This makes palm oil the most environmentally friendly vegetable oil in the world: alternative oils (e.g. sunflower or coconut oil) result in greater environmental damage.

Second, palm oil's high yield makes it the cheapest vegetable oil on the market. The fact that palm oil is an ingredient in so many affordable foods is key here, particularly given our ever-increasing global population size and appetite.

Third, thanks to its natural preservative qualities, palm oil extends the shelf life of food products, thus reducing waste.<sup>21</sup>

With this in mind, environmental activists such as the World Wildlife Fund (WWF) argue that consumers should not boycott products containing palm oil<sup>22</sup>. Avoiding it could, in fact, have far worse environmental and societal consequences.

Take Indonesia, and the role of palm oil in the reduction of poverty, as an example. **Together with Malaysia, Indonesia accounts for around 85-90% of all palm oil production globally. The country is the largest producer; around 3m people directly depend on the palm oil industry and a further 16-17m jobs are created by the supply chain.** While some NGOs lament that these are not high paying jobs, they have undoubtedly transformed the lives of many people, particularly those in central Java<sup>23</sup>.

In WWF's words, "palm oil can be produced in a responsible manner that respects the environment and the communities where it is commonly grown".<sup>24</sup>

**At the heart of palm oil's success is its versatility. Palm oil is used in 70% of cosmetic products, yet most of us don't think about its origins when going about our morning routine with soap bars, toothpaste and face creams.**

<sup>19</sup> Cattle ranching, cultivation of soya bean and oil palm and other large-scale commercial agriculture activities accounted for 40% of tropical deforestation between 2000 and 2010 (Source: FAO's report State of the World's Forests 2020). Palm oil production alone is considered responsible for the loss of 8% of wild forest occurred between 1990 and 2008.

<sup>20</sup> See the Roundtable on Sustainable Palm Oil Certification (RSPO), About sustainable palm oil, for more detail.

<sup>21</sup> While some researchers are experimenting with alternatives such as algae-based oil, or microbes that convert food waste and industrial by-products into synthetic palm oil, growing these technologies on a scale that could compete with palm oil is difficult.

<sup>22</sup> See WWF, "You don't have to give up products containing palm oil!".

<sup>23</sup> For example, many Indonesians who did not have employment opportunities before are now able to send their children to university. The flip side of this is that while the global palm oil market creates opportunities, reports of displaced communities and illegal land grabs are not uncommon. Growers also drain peatland to create new palm oil plantations, with this land becoming highly flammable. Thousands of people in Indonesia have suffered acute respiratory infections due to the smoke haze and air pollution. See UNICEF, as cited in France24 and Reuters, Areas Burned in 2019 Forest Fires in Indonesia.

<sup>24</sup> See WWF Position Statement (November 2018).



## The winds of change: advocating to increase palm oil yields, sustainably

With the above data on yields, affordability and job creation, ESG advocates within the investment industry support sustainably produced palm oil.

Indeed, the Investor Working Group on Sustainable Palm Oil, which is coordinated by the United Nations Principles for Responsible Investment (UN PRI), is backed by over 60 global investment organisations, representing approximately \$7.9tn in assets under management. Signatories endorse the UN PRI's statement regarding the expectations of companies operating across the palm oil value chain - including producers, refiners, traders, consumer goods manufacturers, retailers and banks - and advocate that these companies adopt and implement the UN's publicly available, "No Deforestation, No Peat and No Exploitation" (NDPE) policy<sup>25</sup>.

What's more, we – at the international business of Federated Hermes – have joined forces with other stakeholders to raise concerns and lobby government authorities in Brazil and Indonesia. For instance, we signed the "Investor Expectations on Deforestation in Cattle Supply Chains" statement, highlighting our expectations of companies with respect to cattle ranching and palm oil production. We are also supporting the "Investor Statement on Deforestation and Forest Fires in the Amazon", which requests that companies demonstrate a commitment to eliminating deforestation within their operations and supply chains<sup>26</sup>.

Good intentions aside, with the global palm oil market expected to enjoy a compound annual growth rate (CAGR) of 5.6% over the 7-year period from 2018-2025<sup>27</sup>, sustainable palm oil production remains a challenge. How can the industry achieve a greater volume of production – by increasing palm trees' yields – and avoid further deforestation?

Currently ill-equipped and undercapitalised smallholders – which represent approximately 34% of Indonesian palm oil production – may hold the answer. These smallholders typically produce half the yield achieved by large scale producers; with better resourcing, this could change. **If Indonesian smallholders catch up to their large scale counterparts, then the industry could deliver an additional 26m tonnes of palm oil, all without further deforestation<sup>28</sup>.**

## The certification jungle: reforming standards and encouraging widespread adoption

At the same time, it is important to ensure that existing and additional production is delivered in a sustainable way. Buyers and investors currently use certification to ensure the sustainability of their purchases but navigating this can be tricky. For one, there is no uniform set of standards in use – some are designed for local markets, some are internationally recognised<sup>29</sup>.

Then, there is the issue of credibility. In obtaining certification, it is not unheard of for producers to cut corners and pay bribes. Rather than providing assurance, some certificates may not be worth the paper they are written on.

Despite this, we would argue that certification is the way forward, provided the underlying standards are strengthened and the process for obtaining certification is made corruption-free. At present, three reputable bodies cover over 60% of palm oil plantations globally. 19% of palm oil production (or 15m tonnes from plantations extending over four million hectares) is certified under the strictest, internationally accepted set of standards known as the Roundtable on Sustainable Palm Oil Certification (RSPO). In Malaysia, an additional three million hectares of plantations have received local certification under the Malaysian Sustainable Palm Oil (MSPO) standard. Likewise, over four million hectares of Indonesia's plantations have obtained the Indonesian Sustainable Palm Oil Standard (ISPO).<sup>30</sup> The certification of 100% of palm oil plantations under strict standards should be our next collective push.

**To this end, we have been working with the UN PRI to strengthen certification standards, especially as they relate to the ISPO, where very little protection is currently afforded to human rights and community livelihoods.**

Equally, we are pushing to improve the process by which certification is granted and remove the risk of malpractice. Here, modern technology – from satellite monitoring to geolocation tracking and blockchain – could be used to enforce certification standards. Investigations on the ground might also complement a company's self-disclosure on ESG matters, as could third-party verification checks by the like of Aidenvironment, RSPO and others.



**While we have no exposure to growers or distributors, in various emerging markets, we have positions in food and cosmetic companies, local banks, and supermarkets selling products containing palm oil.**

## How are the companies we invest in contributing to the sustainable palm oil transition?

It is abundantly clear that the production of palm oil has far-reaching implications.

Palm oil is Indonesia's second-biggest export earner after coal, bringing in more than \$10 billion in 2019 and is key to industries from agriculture to food production and finance<sup>31</sup>. We are mindful of this when it comes to stock selection, considering the specificities of the industries that use palm oil, and related sustainability issues along the value chain. While we have no exposure to growers or distributors, in various emerging markets, we have positions in food and cosmetic companies, local banks, and supermarkets selling products containing palm oil.

<sup>25</sup> See UN PRI, Invest Expectation on Sustainable Palm Oil (April 2019).

<sup>26</sup> See note published by our stewardship team, EOS at Federated Hermes (EOS), "Playing with Fire" (September 2019).

<sup>27</sup> As per Global Palm Oil Industry (September 2020).

<sup>28</sup> See World Resource Institute, Intensification by Smallholder Farmers Is Key to Achieving Indonesia's Palm Oil Targets (April 2018).

<sup>29</sup> For a review of the principal oil palm sustainability standards, see Forest Peoples Programme (2017). It concluded that the Roundtable on Sustainable Palm Oil (RSPO) has the strongest set of requirements, followed by, in declining order of ranking, Roundtable on Sustainable Biomaterials (RSB), Sustainable Agriculture Network (SAN), International Sustainability & Carbon Certification (ISCC), Malaysian Sustainable Palm Oil (MSPO) and the Indonesian Sustainable Palm Oil (ISPO).

<sup>30</sup> See EFECA Briefing Notes, Palm oil certification schemes.

<sup>31</sup> \$10 billion is equivalent to See Bloomberg, Time is Running Out to Save the Last of the World's Rainforest.

**Unilever Indonesia**, our consumer stock in the country, benefits from Unilever's group-wide approach to palm oil. The group is one of the largest users of palm oil globally and aims to use only RSPO-certified palm oil.<sup>32</sup> It implements procurement and supply chain management initiatives to improve traceability and enforcement, such as blockchain technology, geolocation data and satellite imagery. It also maintains a public database of suspended suppliers, as it believes transparency to be key in making the industry more trustworthy. The company has set an ambitious target to achieve a deforestation-free supply chain by 2023. Furthermore, it helps independent smallholder farmers to obtain the certification and/or improve their yield and it supports regenerative agriculture overall.

According to the WWF, Unilever's approach to palm oil sustainability scores very highly, but currently lags the likes of Ferrero, which strengthened its approach (and reached the top of the rankings) after criticism threatened the reputation of its brands.<sup>33</sup>

For Forest 500 – an organisation that identifies and ranks the most influential companies and financial institutions in forest risk commodity supply chains – Unilever ranks second globally, after PepsiCo Inc<sup>34</sup>.

**LG Household & Healthcare (LG H&H)**, our Korean manufacturer of cosmetics and household cleaning products, has held RSPO certification since 2014<sup>35</sup>. LGH&H's policy recognises the severity of issues related to workers' rights and the reckless environmental destruction caused by unsustainable palm oil production. The company will immediately terminate contracts with suppliers that violate human rights in producing palm oil.

92% of the palm oil used by **China Mengniu Dairy**, our food company in China, is RSPO certified. All materials used in the company's packaging has also received Forest Stewardship Council (FSC) certification. We will continue to engage with the dairy company to strengthen its commitment and disclosures regarding sustainable palm oil.

Leading Mexican food retailer, Wal-Mart de Mexico S.A.B. de C.V. (**Walmex**), also has ambitions to eradicate deforestation from its palm oil and paper supply chain, in line with the UN Sustainable Development Goals (UN SDGs). We will soon find out if Walmex achieved its internal target of zero deforestation by 2020; encouragingly, 85% of its suppliers in 2019 held a sustainable palm oil certification. Walmex's eventual aim is to have all private brand products source their palm oil with zero net deforestation, in accordance with the principles and criteria of the RSPO, or equivalent. According to the WWF, Walmart's group approach to palm oil sustainability is above average<sup>36</sup>.

We covered **PT Bank Rakyat Indonesia (BRI)** in a previous issue of ESG Materiality. Loans related to palm oil are not material - accounting for only about 3% of BRI's loan book, as of December 2019<sup>37</sup>. Still, BRI's Sustainable Finance Action Plan and sustainability report cover this segment in detail. As a condition for new loan approval, the bank requires clients to follow international labour laws, have RSPO or ISPO certification and complete an environmental impact assessment. We are encouraged by the progress made, and our engagement efforts now look to bolster certification coverage to 100%, with preference for RSPO<sup>38</sup>.

The same is true of **Bank Central Asia (BCA)**. Loans to the edible oil sector represent only 4% of the bank's total loan book, as of December 2019<sup>39</sup>, and BCA's financing policy asks corporations to complete an environmental impact analysis assessment. The bank also oversees certification and monitors the compliance of companies with standards such as the ISPO or RSPO. We are engaging to expand the bank's coverage to 100%<sup>40</sup>, strengthen its due diligence process and either end its exposure to controversial clients or vigorously engage with them to drive change.

### Sustainable palm oil: a commitment beyond the financial

The FAO reports that an estimated \$200bn p.a. is required to finance cattle, soya bean, palm oil, and pulp/paper production free of deforestation.<sup>41</sup> This figure sounds large, but it is small when compared to current fiscal incentives for agriculture, which amount to over \$700bn p.a.<sup>42</sup> and subsidies for fossil fuels, which were estimated at around \$5.2tn in 2017.<sup>43</sup>

Nevertheless, the fight against deforestation will require a commitment that is more than financial; advocacy is key to driving sustainable practices at the company and industry level. As a collective, we should encourage the wider adoption of sustainability certification among companies involved in palm oil production, and work with awarding bodies and the UN PRI to improve the standards and processes applied. In terms of enforcement, we support investigations on the ground and the use local sources to complement a company's self-disclosure on ESG matters. The Forest Peoples Programme (FPP) mentions the need for "ground-truthing" in this regard<sup>44</sup>.

Palm oil can be grown sustainably. To realise this goal, we will need to engage extensively with companies involved in the palm oil supply chain, but our outlook remains positive. With rates of deforestation declining globally, significant progress being made by leading companies, and mounting pressure from investors and other stakeholders alike, it would seem an end to deforestation may come sooner rather than later.



**Palm oil can be grown sustainably. To realise this goal, we will need to engage extensively with companies involved in the palm oil supply chain, but our outlook remains positive.**

<sup>32</sup> In 2019, it achieved 95% sustainably sourced palm oil and palm kernel oil for its core volumes (see Unilever, Transforming the Palm Oil Industry).

<sup>33</sup> See WWF's palm oil buyers scorecard, 2019.

<sup>34</sup> See Forest 500.

<sup>35</sup> LG H&H's business sites of Ulsan and Onsan in fact became the first to receive RSPO Segregation Certification in 2014 for the entire production process, from raw material storage to shipment. See the company's CSR report, 2019.

<sup>36</sup> See WWF's palm oil buyers scorecard, 2019.

<sup>37</sup> See the company's sustainability report, 2019.

<sup>38</sup> At the end of 2019, 80% of the bank's total loan book for palm oil had certification (up from 65% in Dec 2018). Certification for the remaining 20% was ongoing. The Bank also considers the protection of surrounding communities and conservation areas when reviewing the mapping of plantation areas.

<sup>39</sup> See p.127 of the company's annual report, 2019.

<sup>40</sup> At the end of 2019, 90% of the bank's total loan book for palm oil had certification, an impressive improvement considering this number stood at 57% in December 2018. See BCA's sustainability report, 2019, for more information.

<sup>41</sup> See FOA, The State of the World's Forests, 2020.

<sup>42</sup> See OECD, Agricultural policy monitoring and evaluation, 2019 (as quoted in FOA, The State of the World's Forests, 2020, p.147).

<sup>43</sup> See Coady, D., Parry, I., Le, N.-P. & Shang, B, Global fossil fuel subsidies remain large: an update based on country-level estimates, 2019 (as quoted in FOA, The State of the World's Forests, 2020, p.147).

<sup>44</sup> "Ground-truthing" is defined by the FPP as, "The use of information about the actual situation on the ground, gathered from primary or secondary sources that are independent of companies in the supply chain, as opposed to paper-based compliance indicators and company self-reporting". See FPP, Ground-truthing to improve due diligence on human rights in deforestation-risk.

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