

# Deforestation Report 2023

Forests are essential to society and our economy. According to the UN Environmental Programme, around 1.6 billion people depend on forests for their livelihood and tropical forests host over 80% of terrestrial species<sup>1</sup>. They also provide critical ecosystem services such as climate and water cycle regulation and soil erosion prevention. The protection and restoration of forests is vital for climate mitigation and to maintain functioning ecosystems, and in turn underpin the economy and support sustainable livelihoods.

Given links to both climate change and biodiversity loss, deforestation presents a systemic risk for financial markets and may limit our ability to create long-term, sustainable wealth for our clients and their beneficiaries. Deforestation and associated human rights violations linked to agricultural production may present financially material risks to financing and investment activities through operational, supply chain, regulatory, litigation and market risks. These risks could arise, for example, through reputational harm or changing consumer preferences that impact the company or financial institution associated with deforestation, conversion or human rights abuse. It could also come through the imposition of higher costs or fines by governments and regulators. We therefore take the view that contributing to efforts to eliminate deforestation is an outcome that is fundamentally in the long-term financial interests of our clients and therefore part of our fiduciary duty. Our goal is to drive change in the real economy.

In 2021, we signed the financial sector commitment to eliminate commodity driven deforestation alongside over 30 financial institutions representing a total of US\$8.7 trillion<sup>2</sup>. As part of this commitment, we committed to report on our assessment of commodity-driven deforestation risk and mitigation activities across our portfolios.

As well as publishing this report, we have completed the annual review of our Deforestation Policy Statement.<sup>3</sup> As part of this process, our real estate debt and private equity portfolios have now been brought into scope of the policy statement.

## Advocacy

The risks associated with biodiversity loss and the decline of natural habitats have risen up the investor agenda, with COP 15 in Montreal solidifying the importance of the topic for all stakeholders. The World Economic Forum in 2023 identified biodiversity loss and ecosystem collapse as the fourth most severe global risk over the next 10 years.<sup>4</sup>

As co-chair of the Finance for Biodiversity Foundation's public policy and advocacy working group, we advocated for an ambitious Global Biodiversity Framework (GBF) to be agreed at COP 15. We focused on the need for the GBF to require public and private financial flows to be aligned with global biodiversity goals and targets. For a year and a half leading up to the conference, the Public Policy Advocacy working group followed the negotiations, engaged bilaterally with member states, and provided suggestions for the draft text. We developed three position papers (Part One<sup>5</sup>, Part Two<sup>6</sup>, Part Three<sup>7</sup>) for each round of negotiations to explain the position and rationale behind the text suggestions. We attended international biodiversity negotiations virtually in August 2021, in Geneva in March 2022, and in Montreal in December 2022.

At COP 15 the Kunming-Montreal Global Biodiversity Framework was adopted by almost 200 countries. This features a target to protect at least 30% of land and seas by 2030, and addresses key issues related to biodiversity loss, such as subsidies and the financing gap. There is a requirement for financial flows to be aligned with both the 2030 targets and the 2050 vision, which should stimulate action over the short, medium and long term. In addition, governments will be required to ensure that large companies and financial institutions assess and disclose their risks, impacts and dependencies on biodiversity throughout operations, value chains and portfolios.

Since COP 15, we have been advocating for ambitious implementation at national level. For example, we supported the Global Witness campaign on the proposed amendment to the UK Financial Services and Markets Bill to extend the due diligence requirements to the financial sector when investing in or lending to forest risk sectors. This amendment had broad support and passed through the House of Lords but was defeated in the House of Commons. The UK Government agreed to explore other options to encourage or require financial institutions to conduct due diligence on deforestation. We are also members of the Investor Policy Dialogue on Deforestation (IPDD) Consumer Countries Working Group.

As well as engaging with governments and regulators, we have also sought to influence other key stakeholders in order to improve data availability and quality, which will support our own risk assessment and mitigation activities.

In recognition of the need for better disclosure frameworks on nature-related issues, including deforestation, we joined the Taskforce on Nature-related Financial Disclosures (TNFD) Forum and provided feedback on the draft recommendations. Following the publication of the TNFD recommendations, we piloted elements of the TNFD disclosure framework in our latest [Climate-related Financial Disclosures Report](#).

<sup>1</sup> UN Environment Programme, "UNEP and Biodiversity" (September 2020)

<sup>2</sup> Race to Zero, "Financial Sector Commitment Letter on Eliminating Commodity-Driven Deforestation" (November 2021)

<sup>3</sup> Federated Hermes Limited, "Policies & disclosures"

<sup>4</sup> World Economic Forum, "Global Risks Report 2023" (January 2023)

<sup>5</sup> Finance for Biodiversity, "Aligning financial flows with biodiversity goals and targets" (February 2022)

<sup>6</sup> Finance for Biodiversity, "Aligning financial flows with biodiversity goals and targets, part II" (June 2022)

<sup>7</sup> Finance for Biodiversity, "Aligning financial flows with biodiversity goals and targets, part III" (December 2022)

Data providers are also key to supporting financial institutions’ risk assessment and mitigation activities. As part of the Finance Sector Deforestation Action initiative, we took part in a collaborative engagement with data providers on the need for improved deforestation data on companies. Access to more detailed data for a wider range of companies is important to allow investors – particularly those who have made commitments on deforestation – to enhance their analysis of investees. As an initial step, a letter was sent to a range of key data providers setting out the kind of data investors are looking for to assess their exposure to deforestation risks and impacts, including which commodities a company is exposed to and whether they have made any conversion-or deforestation-free commitments. Following these letters, the group met with several data providers who responded to the letter. During these sessions, we outlined the information we need as investors to assess our investments in relation to deforestation. The data providers also shared the biodiversity- and deforestation-related products they had on offer or were planning to release, and we were able to provide feedback on these. These meetings put forward a coherent request from the industry to data providers, and also enabled us to understand what data we may have access to in future. We look forward to seeing the data providers move forward with some of these products.

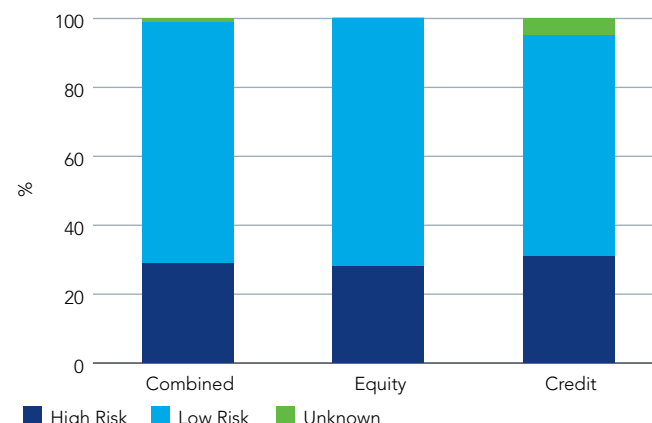
We have also been involved in the development of ForestIQ. ForestIQ is a new data platform for financial institutions which brings together a range of data sources on corporate exposure to deforestation. The platform has been developed by an alliance of not-for-profits – Global Canopy, the Stockholm Environment Institute and ZSL – in close consultation with several financial institutions, including Federated Hermes Limited.

### Public markets

In line with our commitment on deforestation, we have assessed our potential exposure to commodity-driven deforestation. In line with the recommendations from Global Canopy, our first step has been to identify which of our investments are in high-risk sectors for exposure to commodity-driven deforestation. We have used Global Canopy’s list of high-risk sectors to conduct this analysis.<sup>8</sup> Throughout the course of 2024, we will continue to develop our risk assessment on deforestation.

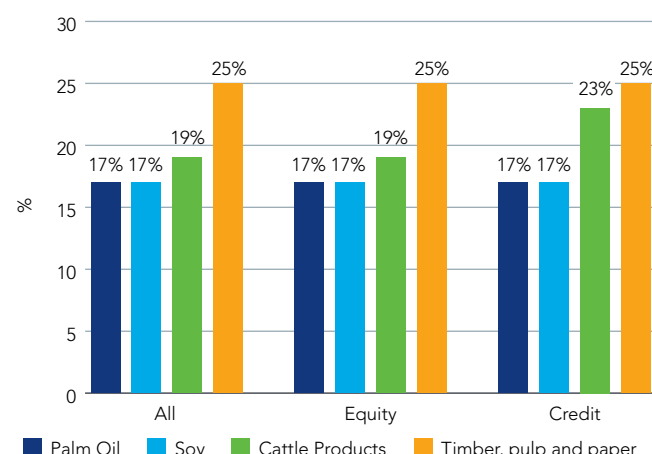
Figure 1 below shows the proportion of our assets under management (AUM) in public market strategies which is at potential high-risk of exposure to commodity-driven deforestation, based on sector analysis. Figure 2 further splits this data out into the key forest-risk commodities and shows that timber, pulp and paper is the most common commodity for those investments in sectors at high risk of exposure to forest-risk commodities. This analysis is based only on sectors and does not assess whether companies have actual exposure to these commodities.

**Figure 1:** Public markets exposure (% of AUM) to sectors at high risk of exposure to commodity-driven deforestation in FHL shareholder and participating funds (credit and equity)



Source: FHL, Global Canopy, as at 31 December 2022.

**Figure 2:** Public markets exposure (% of AUM) to potential forest-risk commodities, identified through sector at risk analysis in FHL shareholder and participating funds (credit and equity)



Source: FHL, Global Canopy, as at 31 December 2022.

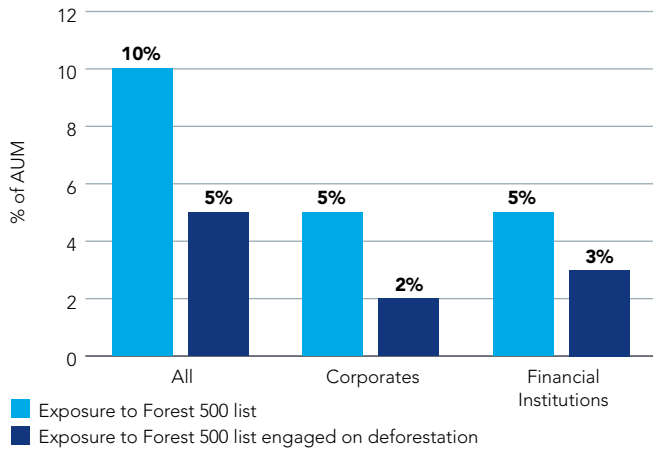
In order to understand which of our investments are most at risk of deforestation, we have run our holdings against the Forest 500 list. Global Canopy’s Forest 500 list ranks the most influential companies driving tropical deforestation. The list focuses on the 350 companies with greatest influence on tropical deforestation, based on their exposure to forest-risk commodities, and the 150 financial institutions which are providing the most finance to them. It ranks them based on the strength and implementation of their commitments on deforestation and human rights.<sup>9</sup>

9.7% of FHL’s public markets AUM is on the Forest 500 list (as at 30 September 2023). Figure 3 shows the proportion of our total public markets AUM on the Forest 500 list, alongside engagement information. FHL has an even exposure to corporates and financial institutions on the Forest 500 list and approximately 50% of names held by FHL in our public markets strategies on the Forest 500 list are being engaged on deforestation.

<sup>8</sup> Global Canopy “Eliminating Commodity-Driven Deforestation: Finance Sector Roadmap” (December 2022)

<sup>9</sup> Forest 500

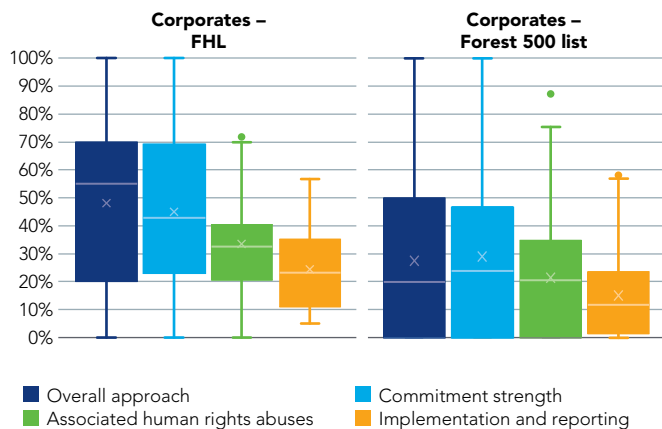
**Figure 3:** Public markets exposure (% of AUM) to corporates and financial institutions on the Forest 500 list in FHL shareholder and participating funds (equity and credit)



Source: FHL, Forest 500 as at 30 September 2023.

There are four modules in the Forest 500 rankings which are: overall approach, commitment/policy strength (commitment strength for corporates and policy strength for financial institutions), associated human rights abuses and implementation and reporting. Figure 4 shows the distribution of our holdings’ Forest 500 scores across the four modules compared to the distribution of the complete Forest 500 list’s scores, with Figure 4a focusing on corporates and Figure 4b focusing on financial institutions. The figure shows that for both FHL’s exposure to the Forest 500 list and the complete Forest 500 list, corporates tend to perform better than financial institutions across all four modules. We would like to see financial institutions improve their disclosure on their exposures to deforestation related activities; this will be an area of engagement for FHL as we look ahead. The names on the Forest 500 list (both corporate and financial institution) that FHL is invested in tend to perform better in the rankings, across all four modules, compared to the full list.

**Figure 4a:** Forest 500 score distribution of corporates broke down by module of full Forest 500 corporate list and FHL’s exposure to Forest 500 corporate list.



Source: FHL, Forest 500 as at 30 September 2023.

We will continue to further our assessment on commodity-driven deforestation risk in our portfolios by exploring further datasets. We will use this initial analysis to focus our engagement efforts in 2024.

### Biodiversity Equity Strategy

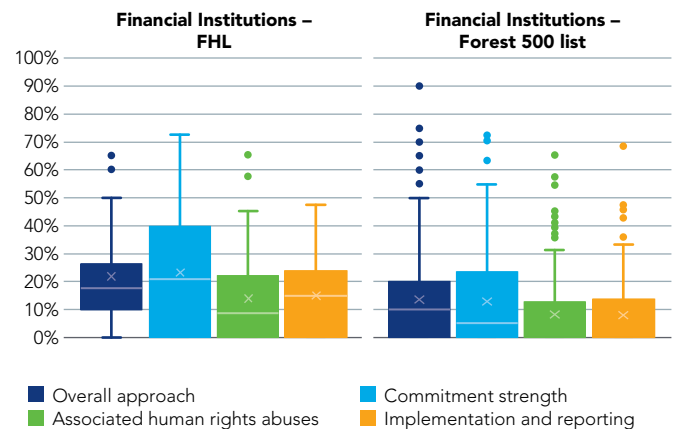
We launched our Biodiversity Equity Strategy in Q1 2022. The team at FHL has extensively researched the major regional and global threats to biodiversity and have defined six themes for the Strategy: land pollution, marine pollution and exploitation, unsustainable living, climate change, unsustainable farming, and deforestation. These discrete themes contain businesses which help mitigate the loss of, or provide solutions to, the specific biodiversity risks they bear. Each of these themes has multiple sub-verticals that are aligned to specific UN SDGs.

We look for best in class companies, which help preserve or replenish biodiversity. For each company, we analyse financials, ESG factors, and complete a biodiversity assessment to determine company impacts and dependencies. We seek to quantify this, where possible, through our impact database. Engagement with portfolio companies is a core aspect of the strategy, with a dedicated Lead Engager in place. The specific engagement objectives vary by company and sector but include asking companies to assess and disclose their impacts and dependencies on biodiversity and scale up parts of the business that are addressing biodiversity loss.

Within our deforestation investment theme, we focus specifically on the deforestation from non-farming uses. We identify businesses which: (i) directly prevent deforestation, (ii) reduce the intensity of timber use in existing product markets, or (iii) sustainably manage forest assets.

Using our new proprietary Federated Hermes Biodiversity Impact Database, we are able to present our impact data on an aggregated, cross-company basis. We have extended our

**Figure 4b:** Forest 500 score distribution of financial institutions broke down by module of full Forest 500 financial institution list and FHL’s exposure to Forest 500 financial institution list.



Source: FHL, Forest 500 as at 30 September 2023.

<sup>10</sup> The shape of the charts in Figures 4a. and 4b. show how the data is distributed and highlights any outliers. The white line splitting the box in two represents the median value and the X within the box shows the average value. The bottom of the box represents the lower quartile, and the top of the box represents the upper quartile. The values at which the vertical lines stop at the top and bottom are the respective upper and lower values of the data. The single points on the diagram represent outliers.

original Impact Database, launched in 2020, to create three bespoke biodiversity metrics, as well as having qualified 10 biodiversity-adjacent metrics, from our original Impact Database. As well as producing company-level impact, our database allows us to report on the impact of our strategy's assets under management. Our database draws on data from company, sector and industry reports. Put simply, these metrics depict our estimate of the total impact that the companies in which we are invested have delivered in 2022, which includes 7.4m hectares of land area preserved, where change of use has been avoided. We also scale the metrics to demonstrate the impact accomplished through the capital we deploy – US\$38m as at 31 December 2022 – on behalf of our clients, thereby reflecting our ownership of each company held in our portfolio. The impact achieved by capital deployed in 2022 was 4.1k hectares of land area preserved, where change of use has been avoided.<sup>11</sup>

### Case study: Brambles

As the world's largest supplier of reusable pallets, crates and containers, the Australian-listed company, Brambles, is a major consumer of timber.

Since 2020 the business has sourced all wood from certified sustainable forests while also implementing a two-for-one tree replanting policy that has enhanced its ESG claims.

Historically, Brambles has framed its sustainability approach around climate change but we encouraged the firm to also consider biodiversity impacts at a similar priority during our recent corporate engagement – suggesting, for example, it introduces reporting procedures that comply with the Taskforce on Nature-related Financial Disclosures (TNFD).

According to the Brambles team, the company has held regular communications with TNFD and global peers on how to achieve better reporting on biodiversity metrics.

And rather than settling for 'zero impact', Brambles is now aiming for a positive sustainable approach with a mantra of 'reuse, resilience and regeneration' that will see the business consume less waste and create more resources. As part of the ESG-enhancement, the firm told us it is also committed to tackling biodiversity challenges in addition to the traditional carbon-based reporting.

Following our request for more detail, the Brambles team said the company largely relies on third-party certification, especially from the Forest Stewardship Council (FSC), but has increased scrutiny on how these standards apply across supply chains for biodiversity and other key goals such as social co-benefits.

Furthermore, the group told us that while the firm does not currently lobby for improved policies at a government level to protect and restore nature, Brambles is a strong advocate for circular business models through partnerships with customers.

We expect the Brambles biodiversity strategy to evolve rapidly and look forward to seeing progress in our future engagements.

### Engagement

Investors have a critical role to play in halting and reversing deforestation, especially through engagement with companies and capital allocation. A collaborative initiative called Finance Sector Deforestation Action (FSDA) has been launched to support investors in delivering against the commitment to eliminate commodity driven deforestation through engagement and due diligence. It uses data from Forest 500 and Global Canopy to help identify those companies at risk of having links to deforestation. EOS and FHL are supporting these efforts through collaborative engagements with over 30 focus companies (as at 30 June 2023).

For example, following the FSDA letter that we sent to Yum! Brands, which operates fast food chains such as KFC and Pizza Hut, we met the company's chief sustainability officer together with other FSDA coalition members. We pushed for Yum! Brands to increase commodity traceability in its supply chain.

The company said that all its beef was sourced locally for its restaurants and that less than 2% was sourced from Brazil, which supplies Brazilian restaurants. It underlined the challenge of achieving traceability in its soy supply chain but said it had made efforts to map this and had joined the UK Soy Roundtable. It was good to hear that the company was conscious of emerging deforestation-related regulatory risks, especially in European markets.

We expect companies that source or produce forest risk commodities to commit to deforestation-free and conversion-free production and sourcing by 2025. The commitment should cover all commodities, regions, and suppliers, including indirect suppliers. We also encourage a commitment to achieving full traceability of commodities to source, across all tiers of the supply chain, in order to demonstrate that the company's value chain is deforestation and conversion-free. There should also be an explicit commitment to respect human rights.

Companies should focus on the implementation of the commitment by articulating a clear strategy for how their operations and supply chain will become deforestation and conversion-free. This includes setting clear expectations for suppliers and creating mechanisms to enforce them. Ongoing due diligence and monitoring of suppliers and operations will be critical for effective implementation. Equally, ongoing collaboration will be necessary to tackle this complex issue.

For example, in an October 2022 call with the head of sustainability at JBS, we reiterated our concern about controversies related to the acquisition of cattle raised on deforested land. JBS confirmed the company's target of achieving 100% full traceability of the supply chain by 2025. Currently, 36% of all cattle acquired by JBS can be fully traced.

The company highlighted its engagement with smaller farmers in its supply chain and its provision of technical assistance. Approximately 3,000 small farmers that had been excluded from its list of approved suppliers were reinstated after engaging with JBS and implementing the recommendations made by the company's technical assistance team.

<sup>11</sup> Federated Hermes Limited, "Biodiversity Equity Fund Report - One-year review: 2022-2023" (September 2022)



We continue to engage with companies that are exposed to deforestation risks. Our vote policy also includes a deforestation dimension, which targets companies that are lagging on disclosure and risk management. In 2022, we expanded the policy to look at poor performing financial institutions, as well as companies. In 2022 we recommended opposing directors on the Archer-Daniels Midland board due to concerns that the company had not taken adequate climate and deforestation risk mitigation measures. The company is one of the world's largest agribusiness traders in soft commodities including soy.

## Real Estate

Our Deforestation Policy Statement makes a number of commitments in relation to our real estate assets. This includes a commitment that, as timber is the most material 'forest-risk' agricultural commodity for our Real Estate portfolio, from 2023 we will mandate that all timber and wood products used for structural work and fittings in our new developments and major refurbishments must only come from legal and sustainable sources, which must be verified by certification. All timber used in such projects is required to be Forest Stewardship Council (FSC) certified at a minimum, in line with the expectations set out in the UK Government's timber procurement policy (TPP). This is stipulated in architectural specifications, at which point contractors have the responsibility to use FSC-certified timber. Furthermore, all of our current major development schemes seek to achieve at least BREEAM Excellent rating, which requires the use of certified sustainably sourced timber in construction.<sup>12</sup>

In 2024, we will continue to work on our commitments to:

- Map the source of all the timber and wood product used in our developments and major refurbishments by 2025 by implementing a supply chain due diligence process;
- Explore piloting innovative materials that could reduce deforestation by 2025 in our developments and major refurbishments;
- Engage our supply chain on further ways to minimise our exposure to deforestation risk;
- Introduce guidelines for our property managers on how to reduce the risk of exposure to deforestation in 2024.

## Infrastructure

In 2023 the infrastructure team updated their portfolio company 'sustainability expectations guidance' document, which is shared with investee company management teams. This includes expectations around deforestation including awareness of exposure to or use of forest risk commodities (including in supply chains) and assessment of whether the sources of those commodities are sustainable. A stretch target has also been established encouraging companies to develop a strategy and associated actions to eliminate deforestation connected to forest risk commodities.

In 2023, the infrastructure team collated annual sustainability data for each portfolio company for the year ending 2022. This included a key performance indicator requesting

portfolio companies to disclose 'non trivial exposure to deforestation' covering both the company's direct operations and its supply chains. Seven out of ten companies across the infrastructure team's flagship funds responded. Two of the companies reported having potentially non trivial exposure to deforestation. However, both confirmed that this was due to an understanding that they may be exposed due to the nature of their activities and not based on reported data as a detailed study of operations and supply chains had not been undertaken to date.

Further engagement on the topic with these two portfolio companies is expected in 2024 as well as ongoing monitoring across the broader portfolio.

## Direct Lending

Our Direct Lending team have a series of steps in their investment process to mitigate exposure to deforestation. The first is an exclusion process. The team will not engage with or provide loans to companies that have 5% or above direct revenues (at borrower level) from any of the following business activities below:

- **Conservation restrictions:** removal of primary or high conservation value forests; deforestation of tropical rainforest; damage to UNESCO World Heritage Sites; damage to wetlands registered by the Ramsar Convention; damage to critical natural habitats.
- **Palm oil:** cultivation and production of palm oil that is not certified as sustainable.

For those potential investments not impacted by the list of exclusions, analysis of potential investments is undertaken to form a comprehensive view of existing and potential ESG risks. This includes a question on whether the company is exposed to deforestation in its operations, supply chain or financing and if so whether it has a commitment or policy in place to reduce or remove its contribution to deforestation.

The following are two examples of deals that have been declined by our direct lending in part due to our deforestation approach:

- The team reviewed a loan for a manufacturer of safety products, with rubber gloves a primary product line. While the company had seen a huge earnings boost as a result of Covid-19 increasing demand for disposable rubber gloves, the team declined the transaction due to ESG concerns; the gloves were not biodegradable and there were also concerns around the impact of the rubber plantations on the Malaysian rainforest.
- The team analysed a potential loan to a long-established manufacturer of plywood panels, used primarily in wooden domestic door frames. The drive to switch from plastic frames to wood for sustainability purposes was presented as a key driver of future growth. As part of the due diligence process, the team assessed the key suppliers of wood to the potential borrower. This uncovered a number of issues including claims that the supplier was deforesting a large area of rainforest in Cameroon, without the consent of the local people. For this reason, the team declined the transaction.

<sup>12</sup> BREEAM is the Building Research Establishment (BRE) Environmental Assessment Method, first launched in the UK in 1990. It sets best practice standards for the environmental performance of buildings through design, specification, construction and operation.

**The value of investments and income from them may go down as well as up, and you may not get back the original amount invested.**

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Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

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- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

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