QUILTER CHEVIOT

RESPONSIBLE INVESTMENT

Woods for the trees

How companies are responding to EU Deforestation Regulation

Across Quilter we have identified three thematic engagement priorities. This is part of our natural capital theme.

Natural capital can be defined as the stock of renewable and non-renewable natural resources (e.g. plants, animals, air, water, soils, minerals) that combine to yield a flow of benefits and ecosystem services to society[1].

SDG Alignment

> *If we lose the world's forests, we lose the fight against climate change. Rainforests are our Earth's greatest utility – our planet's lungs, thermostat and air-conditioning system."*

Michael Somare (Former Prime Minister of Papua New Guinea)

Cocoa is now more expensive than copper[2]. Over the last twelve months to the end of March, cocoa bean prices have increased by 166% and 189%, respectively, in the New York and London cocoa bean futures markets[3]. This has a material link to the profitability of major consumer goods groups using the commodity as a product input.

Two countries, Cote D'Ivoire and Ghana grow 60% of the world's cocoa and appear to have hit several environmental limits at once, raising production costs[4]. One of the limits is the lack of virgin forest. Historically, cocoa farmers have discarded older, less productive plots and started again in fresh areas. Cote d'Ivoire and Ghana have lost 80% and 94% of their forests, respectively, over the last 60 years, with the World Economic Forum estimating that roughly one-third of the loss is attributable to expanding cocoa production.

1 Taskforce on Nature-related Financial Disclosures (TNFD)
2 Bloomberg (as of 25th March)
3 https://www.just-food.com/features/cocoa-prices-continue-to-rise-when-might-the-tide-turn/?cf-view
4 https://theconversation.com/cocoa-beans-are-in-short-supply-what-this-means-for-farmers-businesses-and-chocolate-lovers-225992?utm_medium=email&utm_campaign=Imagine%20128&utm_content=Imagine%20128+Version+B+CID_d3c0f66072f08d3449acd563e3bee822&utm_source=campaign_monitor_uk&utm_term=hit%20several%20environmental%20limits

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Cocoa farm expansion is not only directly driving deforestation but contributing to reduced biodiversity that can further reduce crop yields. In deforested areas, wildlife is less able to tolerate increasingly harsh climates, heralding a collapse in key cocoa pollinators. One study found that the climate-stressed farm plots have lost 63% of insect populations[5]. It has been reported that pollinators are now so scarce that some cocoa farmers in Ghana are required to pollinate tree crops by hand[6].

Cocoa is one example of a commodity both driving change and suffering from deforestation impacts, highlighting the positive role that more sustainable agriculture and agroforestry can play in improving the management of nature capital but also the bottom lines of companies using these inputs.

Regulatory change on the horizon

More generally, agricultural commodity production continues to drive global deforestation practices, replacing an average of 5.7million hectares of forests every year[7]. Ending deforestation is an important aim for investors and companies looking to better manage the risks associated with nature loss as well as achieving the global goal to limit the impacts of climate change and achieve 'net zero' emissions by 2050. Policy makers are increasingly scrutinising value chain deforestation practices and the rapidly changing regulatory environment is best represented by a suite of policies being brought forward by the European Union to eliminate deforestation and forest degradation[8]. The most notable piece of legislation is the Regulation on Deforestation-free Products (EUDR) which requires companies to eliminate deforestation and forest degradation from their supply chains and operations starting in 2024. Supplementary EU rules will add a layer of corporate disclosure on deforestation impacts and mitigation plans[9].

Regulation on Deforestation-free Products (EUDR)

The EU Regulation on Deforestation-free Products (EUDR) came into effect on June 29, 2023. The legislation aims to prohibit companies from trading commodities associated with deforestation and forest degradation. In its current form this applies to soy, beef, palm oil, wood, cocoa, coffee, rubber, and some of their derived products, such as leather, chocolate, tires, or furniture.

Ceres, the not-for-profit organisation summarises this as:

"Large to medium companies have until the end of 2024 to verify and prove their products are deforestation-free, with small businesses granted a longer adaptation period (June 2025). To avoid substantial regulatory risks (fines for non-compliance stand to cost 4% of annual revenue), as well as significant litigation and reputational risks, all companies operating or trading products on EU markets must start reporting on their activities. Numerous US domiciled companies will be impacted by the requirements. The increased compliance challenge of sourcing fully traceable raw material has the potential to create supply shortages and other market risks".

It is important that companies start assessing now whether they will be subject to the EUDR and, if affected, bring in appropriate policies and management regimes to mitigate the risks[10].

5 https://www.ucl.ac.uk/climate-change/stories/bees-under-threat-risk-chocolate-lovers
6 https://www.sciencedirect.com/science/article/abs/pii/S1439179121001286
7 World Economic Forum (https://www.weforum.org/agenda/2022/12/these-are-the-5-drivers-of-forest-loss/)
8 The Regulation on Deforestation-free Products (EUDR), Corporate Sustainability Reporting Directive (CSRD), and Corporate Sustainability Due Diligence Directive (CSDDD) are in the process of being finalised.
9 Ceres, 'Assessing corporate action on deforestation amid growing regulatory risk', November 2023 (https://www.ceres.org/sites/default/files/reports/2023-11/Ceres%20Deforestation%20Scorecard%202023.pdf)
10 Ceres, 'Assessing corporate action on deforestation amid growing regulatory risk', November 2023 (https://www.ceres.org/sites/default/files/reports/2023-11/Ceres%20Deforestation%20Scorecard%202023.pdf)

Our engagement

In 2024 Quilter Cheviot launched a thematic engagement with monitored investee companies most exposed to deforestation linked commodity use to better understand how they are managing these risks and preparing for the upcoming regulatory changes. As part of our engagement activities on the topic of natural capital, Quilter Cheviot has been working as part of the 'Forest Champions' program, run by the environmental non-profit organisation, CDP. Within this we have:

- used CDP's repository of company reported data on deforestation linked commodity involvement to identify companies that are most exposed to deforestation;
- combined this with recent external analysis on companies most exposed to the upcoming EU regulation on deforestation[11];
- identified a group of companies where we have material holdings which are most exposed to deforestation linked commodities and have significant activities in Europe.

The target companies selected for engagement were[12]:

This was a focused engagement, targeting a handful of material holdings with the aim to better understand how companies most exposed to deforestation linked commodity use are preparing for a changing regulatory environment. Post-engagement, we will continue to track conversations and outcomes and, where lacking, encourage action and application of best practice frameworks. Key requests include progress towards application of comprehensive no-deforestation policy that applies to all commodities and entire supply chains (including third party and/or indirect suppliers), as well as all markets, product lines and sourcing geographies. This is not an easy task but a crucial step in meeting the EUDR and holistically managing deforestation risk.

Key learnings:

- **Deforestation free targets**: The target companies all have a deforestation policy and deforestation free supply chain targets, most centred around 2025. To achieve these aims all companies used a portfolio of tools to monitor compliance. Typically, this is a combination of local NGO partnerships, satellite monitoring and commodity certification programs. Different tools are more appropriate for certain geographies and commodities. Where sourcing geographies are classified as a low-risk deforestation zone (e.g. US or France), suppliers will not require further monitoring. Certification included use of 'mass balance' systems which certify commodities as deforestation free if most of the raw material providers are certified, potentially blending deforestation risk into company procurement. As things stand, most modern commodity chains are not segregated but are infused with huge numbers of smallholders, cooperatives and aggregators that can make it extremely difficult to trace the origins of every drop of palm oil (or other unit of input).

- **Best practice in palm oil**: Many of the commodities used by the target consumer goods companies have relatively well-established assessment processes. These developments have been driven by efforts to ensure the sustainable sourcing of palm oil. Long established local NGO partnerships and inclusion of more sophisticated monitoring tools (such as satellite technology) has facilitated a large degree of confidence in sourcing higher levels of deforestation-free volumes. Although a smaller user of palm oil, Mondelez appears to be less rigorous, by shifting the burden to suppliers and requiring them to monitor and prevent deforestation.

- **The cocoa challenge**: One of the challenges in creating a deforestation-free primary supply chain for companies such as Nestlé and Mondelez is cocoa. The production process, largely based in West Africa, has multiple sustainability concerns including widespread use of child labour. Currently Nestlé can only verify 43% of cocoa

11 Ceres, 'Assessing corporate action on deforestation amid growing regulatory risk', November 2023 (https://www.ceres.org/sites/default/files/reports/2023-11/Ceres%20Deforestation%20Scorecard%202023.pdf)
12 Mondelez declined our offer to engage. Information is based on company policy and supplementary disclosures.

used as deforestation-free. In contrast, the long-established NGO partnerships and heavy use of satellite monitoring allows the company to claim 96% deforestation-free status in palm oil inputs. The cocoa production market is extremely fragmented with vast numbers of smallholders and given that the plants themselves are often grown under canopy cover, does not lend itself to technologies such as satellite monitoring. Nestlé is an example of a company investing significant resources to improve the performance of the cocoa supply chain and aiming to better segregate its sourcing of cocoa (i.e. sourcing directly from producers) through its 'Cocoa Plan'. Similarly, Mondelez's 'Cocoa Life' strategy aims to use local partnerships to promote more sustainable agricultural practices and monitor the long-term social and environmental impacts. By 2025 the company looks to source all cocoa volumes from farmers taking part in the program.

- **Apparel retailers focus on leather**: For the target apparel companies, leather is the commodity most exposed to deforestation risk. Currently the deforestation monitoring approach relies heavily on certification. We regard certification to be a blunt tool. Leather is often treated as a commodity that is aggregated and processed by quality and therefore can be difficult to trace. Both apparel companies engaged used the 'Leather Working Group' (LWG) certification regime. The LWG mark focuses on certifying tanneries, however, the tannery stage is often too late to catch deforestation as early steps in the chain (such as slaughterhouses) often have no way to track farmer practices. Companies admitted that certification is a tool not a solution and they are aiming to add layered processes to this approach. Both LVMH and Adidas are trialling the use of blockchain technology to track raw materials. Progress is being made and companies are looking to build a toolkit that can provide the level of transparency needed in such fragmented supply chains.

- **Satellite monitoring**: One of the key developments in palm oil supply chain monitoring has been the development and proliferation of satellite monitoring and alerts. This is a tool that is now beginning to be used for soy, timber and some cattle product supply chains. Consumer goods groups are extensively using the tool such as Unilever and Nestlé. Typically, the monitoring technology assesses natural forest cover in the areas connected to mills and plantations in palm oil supply chains and sourcing landscapes in pulp and paper, and soy - sending out alert signals when there is a change in natural forest cover. These alerts prompt an investigation. Although used for other commodities, as mentioned above, satellite imaging has limited applicability where crops are grown under forest cover, like cocoa. In these instances, companies tend to rely more on local partners and certification to verify compliance on-the-ground. Satellite technology has made it possible to monitor the same tract of forest to see if the cover has changed, quarter-by-quarter or year-by-year. The development of this technology marks a meaningful change from trying to assess deforestation risks on foot. It means that work on the ground can focus on acting in the most critical locations and companies can engage suppliers with factual and accurate information, increasing transparency and strengthening accountability. Satellite technology is expensive, but a key verification tool recommended by EUDR, and we were encouraged to see widespread use.

- **Decommodification**: Unilever and Nestlé's deforestation strategies focus significantly, in terms of time and resource, on supplier partners. The process involves an element of decommodification, where traceability and long-standing relationships are prioritised, particularly for palm oil. Given this more stable, yet perhaps more static supply chain, companies like Nestlé are looking to build additional flexibility into raw material sourcing by nurturing multiple supplier markets for commodities when one country or supplier looks too dominant. This is done by building capacity beyond current sourcing requirements. The company has verified more sustainable palm oil suppliers than it currently uses, but the buffer helps mitigate supply shocks. Both Nestlé and Unilever are also partnering with peers to carry out 'landscape' verification where entire localities and regions are assessed as low risk or deforestation free, again building sustainable supply chain resilience. For Unilever this process involves a more direct sourcing strategy, an important part of which is a $360 million investment in a palm oil processing facility in northern Indonesia, which refines the directly sourced oil and kernels. The company has also piloted soybean refineries in Brazil. Currently these facilities do not represent the majority of sourcing but is one of the best ways to improve transparency and is a direction of travel.

- **Preparedness for EUDR**: Most companies engaged believed implementation of EUDR will be messy and undoubtedly benefit large companies with others struggling to afford to adapt. Some companies may also need to bifurcate supply chains, by routing deforestation-free commodities to Europe and other non-verified materials elsewhere. This will be expensive and complicated. All the target companies, apart from Mondelez, were aiming to verify all relevant commodities concurrently so they would not need to re-route commodity inputs. All companies, perhaps unsurprisingly, felt well-prepared and we would tend to agree. Although the apparel companies are exposed to some leather related deforestation risk, most commodity inputs are sourced from low-risk geographies.

The brand positioning over both companies also promotes 'sustainable' values, making these efforts and investment a core part of business strategy. LVMH is targeting traceability as a consumer facing offering. An example of which is Louis Vuitton's project to build a more direct relationship with cattle farmers in France with the end goal of providing full traceability information to consumers, down to the name of the farmer producing the purchased product input. When it comes to consumer goods companies, Nestlé and Unilever look well placed to meet the upcoming regulatory requirements, taking a global and multi-faceted approach to preventing deforestation in supply chains. We expect Mondelez to also comply with upcoming requirements, but outside of the cocoa suppliers, we recognise its reliance on certification and a staged approach to eliminating deforestation, with materials used in the European business to be targeted first.

- **Unintended consequences**: The EU Deforestation Regulation aims to implement a regime of high-quality due diligence and risk assessment for any commodity derived inputs entering Europe. As mentioned, companies where we have consumer goods exposure are well positioned and confident that their approach is among best practice, but given the extreme complex of commodity value chains, it will be difficult to guarantee zero deforestation risk for all commodity inputs unless there is some flexibility in the way the regulation is implemented. On initial reading some companies were concerned there is an asymmetric focus placed on raw commodities brought into the EU trading area rather than manufactured products. An unintended consequence that could lead to companies moving manufacturing operations outside of the EU and imported finished products. Whether this happens will again be dependent on the finer details of implementation.

Summary

We are comfortable that the target companies are well positioned for the upcoming legislative changes and have or are developing robust processes to mitigate the regulatory risks involved. There will be challenges in complying to the letter of the law and we will monitor progress towards targets in this area. Despite this, the resources committed to forest risk strategy and efforts to improve traceability by sourcing more directly from producers, positions these companies to comply. This is partly a style factor, where we have most material exposure to deforestation risk, it is in global quality companies that have the resources and long-standing partnerships in commodity regions to manage this issue effectively relative to peers. Smaller companies may struggle.

Final thoughts

Given the scale and ever evolving scope of managing deforestation risk there is progress to be made. The apparel industry is both less well-resourced but also less exposed to widespread deforestation risk. For both apparel companies engaged, the primary focus was leather, of which only a third of leather inputs were sourced from high-risk geographies. Despite this relatively small footprint, both companies aimed to implement a deforestation and raw material traceability strategy that goes beyond EUDR. There is a notable absence of the satellite tracking of deforestation demonstrated by consumer goods companies, and currently the heavy use of certification processes by apparel companies may lead to an incomplete picture of the deforestation risk in non-European supply chains. However, the development of block-chain based traceability tools and local partnerships should enhanced transparency. We also saw best practice examples of attempts to quantify deforestation intensity, with LMVH calculating the deforestation intensity of its supply chains for three key materials (leather, timber and palm oil): amounting to 70 hectares per year (including animal feed). By calculating this intensity, the group can establish priorities for action and measure the progress made. We have seen few examples of companies attempting to quantify their impact on nature and we welcome the pioneering of this scienced-based, comparable approach. The premium apparel industry is also supported by consumer interest in this topic, and we will continue to monitor forest risk strategy development.

Conversely, for consumer goods groups like Unilever, most sales are now in emerging markets where the company believes issues such as deforestation are less important to consumers – as it is typically a developed market dominant topic. It can be challenging to turn a strong approach on deforestation into shareholder value. However, EUDR crystallises what was once more of a potentially intangible reputational risk. When it comes to costing efforts to managed deforestation risk, there is an assumption that the consumer will not want to pay, so the expense is integrated into the cost of goods sold. Wherever improved sustainability programs are put in place they are also typically looking for productivity gains. The two need to go hand in hand to make the change effective, using the efficiency gains to cover the cost of sustainability related resourcing. An example of this could be using less land to produce more, though adopting more sophisticated agroforestry techniques. These developments also help to expand the size of the sustainable commodity market and prevents better resourced companies hoovering up the least impactful raw materials, without improving worldwide production standards.

Analyst view – Chris Beckett, Head of Research

The increase in cocoa prices this year demonstrate the materiality that deforestation and unsustainable agriculture is having on corporate profitability. Our work has also demonstrated the complexity of the issue and links to other social as well as environmental issues. The best companies are aiming to improve agricultural productivity and household incomes so reducing the economic pressure to use child labour. So far these issues do not resonate as much with consumers as they should but the best companies are proactive in risk reduction not just reactive to failings.

Next steps

Where we have exposure to the consumer goods industry most companies tend to be better resourced but also far more exposed to deforestation risk. The early recognition of palm oil as a key driver of deforestation in the early 2000s, prompted many of these companies to look more closely at deforestation risk. This awareness has led to the earlier adoption of deforestation policies, targets and the use of more sophisticated monitoring tools, such as satellite technology. The establishment of more detailed, directly supplier partnerships is a direction of travel. These companies are both further ahead but also have further to go. For the most part, the companies look on course to meet deforestation-free targets, but challenges remain in commodities such as cocoa. Cocoa does not lend itself well to satellite monitoring and the fragmented nature of the market has encouraged some companies, like Nestlé and Mondelez to mobilise significant resources to establish a more segregated supply chain. While the target consumer goods companies demonstrate best practice in many areas, we will continue to monitor efforts to establish and maintain elevated levels of transparency across all commodities inputs required to manage the new regulatory risk brought about by EUDR.

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