Schroders

Managing Deforestation risk within our investment portfolios

A year in review

January 2024

Contents

Introduction

The costs of inaction on biodiversity loss are huge. With more than half of our global Gross Domestic Product (GDP) dependent on the natural world[1], nature loss is integral to investment risk. As a global investment manager, we aim to mitigate risks in the portfolios we manage for our clients. With around 80% of biodiversity on land residing in forests, credible action on reversing nature loss must start with ending deforestation[2].

Deforestation poses a potentially significant risk to the value of the investments we manage on behalf of our clients, including regulatory risks, risks to consumer and investor sentiment and operational and supply chain risks[3]. We also know that ending deforestation is critical to meeting global goals to minimise and mitigate climate change.

In 2021 we therefore committed to use our best efforts to eliminate forest-risk agricultural commodity driven deforestation activities at the companies in our investment portfolios and in our financing activities by 2025[4]. In our Group Biodiversity and Nature Position Statement, we set out our action plan to implement this commitment. In February in 2023, we were ranked first amongst financial institutions in Global Canopy's Forest 500 report[5], and most improved from previous years[6]. While this ranking is recognition of the significant action we are taking, we also acknowledge more needs to be done. We want to be transparent about the progress we are making with this commitment and any barriers and challenges we have identified throughout the year.

This update provides an overview of how we have delivered on this action plan in 2023. We also set out our proposed next steps in 2024 and beyond.

Identifying our exposure to commodity driven deforestation

We conducted an exposure analysis of our holdings to the four main forest risk commodities (beef, timber, soy, and palm oil). We used a variety of data sources to assess these factors, to identify a priority list of companies with deforestation risk in our investment portfolios. This allowed us to assign companies to three different risk tiers based on their likelihood of exposure to commodity-driven deforestation, and a materiality threshold based on Schroders' holding size at the time of assessment:

- **Tier 1:** Producers and processors of forest risk commodities
- **Tier 2:** Companies likely exposed to commodity driven deforestation through their supply chain
- **Tier 3:** Companies with deforestation risk that don't meet the materiality thresholds for Tiers 1 or 2

We have a relatively small proportion of Tier 1 companies in our investments. This is partly due to the nature of food production which is primarily in the hands of private companies and smallholder farmers. A significant amount of our exposure is through Tier 2 companies, where large cap food retailers and consumer staples have significant supply chain exposure to deforestation risk commodities.

[1] How much is nature worth? $125 trillion, according to this report | World Economic Forum (weforum.org).

[2] https://www.weforum.org/agenda/2021/03/deforestation-biodiversity-protect-international-day/.

[3] Global Canopy: Business Fails to Hear the Alarm on Deforestation; You can find out more about these risks here.

[4] racetozero.unfccc.int/wp-content/uploads/2021/11/DFF-Commitment-Letter-.pdf; Over 30 institutions representing close to USD 9 trillion, made the Financial Sector Commitment on Eliminating Commodity-Driven Deforestation, at COP 26.

[5] https://forest500.org/rankings/financial-institutions/.

[6] forest_500-2023_annual_report.pdf (forest500.org).

The assessment of exposure to forest risk commodities is not necessarily indicative of deforestation taking place. Effective management action can significantly reduce that risk. Schroders has also developed a proprietary Deforestation Scorecard which analyses the quality of company management regarding this issue across areas such as:

- Strength of deforestation commitments and policies
- Governance and risk management
- Traceability of supply chains
- Certification and compliance; and
- Partnerships and compliance

This draws upon datasets from MSCI, CDP Forests, Refinitiv Eikon and Forest500 and provides an indication of strengths and weaknesses within company practice[7].

Engaging with our highest risk holdings

We have been engaging with companies on deforestation risk for several years[8]. In 2023, we scaled up to a systematic approach to engaging with our highest risk holdings, engaging with 293 companies in total on deforestation risk. We have achieved this scale by providing tools and training for our investment desks to lead engagements with investee companies on deforestation; communicating our expectations to 158 Tier 2 and Tier 3 companies through a mass engagement letter (see our Group Nature and Biodiversity Position Statement for this list of expectations); as well as participating in collaborative engagements with other institutional investors via Finance Sector Deforestation Action (FSDA).

We have also used our influence to input into public policy and regulation. For example, Andy Howard, our Global Head of Sustainable Investment, gave evidence to the UK's Environmental Audit Select Committee as part of their inquiry into sustainable timber and deforestation[9], to discuss our insights into deforestation and investment risk ahead of the UK introducing its own deforestation due diligence regulations. We have also engaged with countries such as Malaysia and Brazil on deforestation through discussions on their sovereign bond issuance programs.

Figure 01: Breakdown of engagements[10]

Engagement type	Number of companies engaged in 2023
Biodiversity engagements	399
Of which (Deforestation) engagements	293
Of which (Mass engagement letter)	158
Of which (Direct engagements)	151

Source: Schroders, 2024.

[7]See here for an overview of our scorecard methodology: Q&A: why tackle harmful deforestation – and how? (schroders.com)'

[8]Palm oil: how bad is it really? (schroders.com).

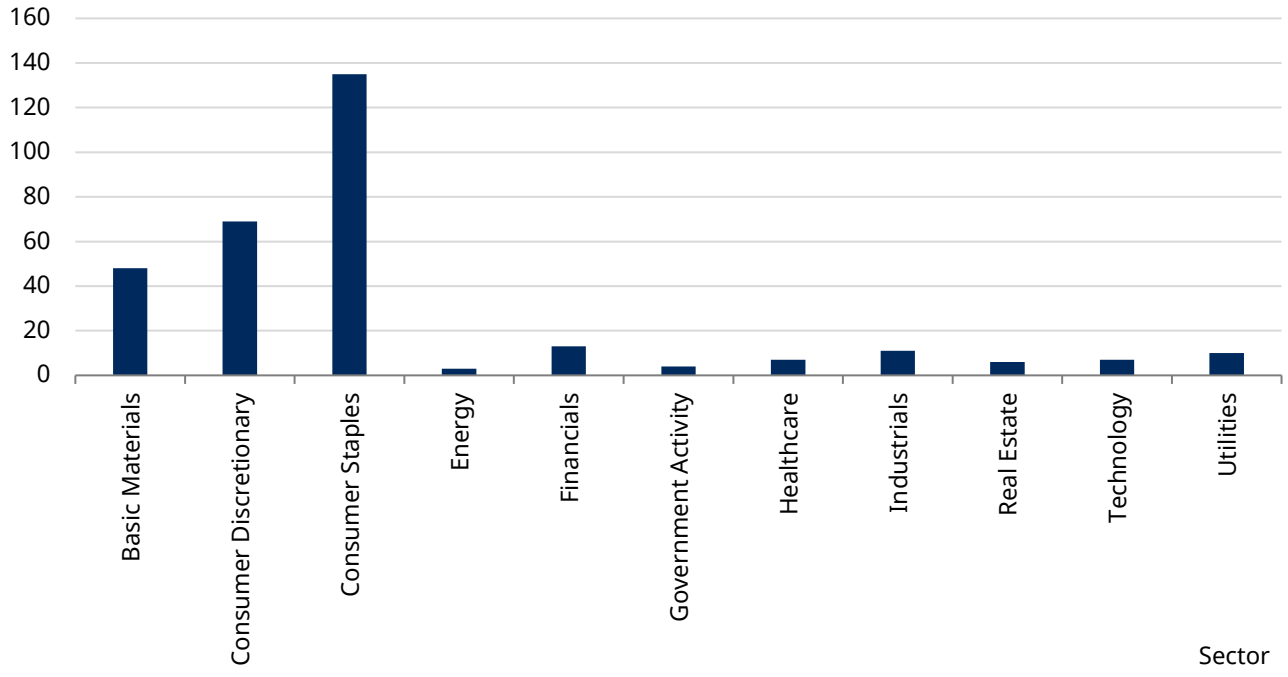
[9]Sustainable timber and deforestation - Committees - UK Parliament.

[10] Please note, we had several follow up direct engagements with companies we targeted as part of the mass engagement exercise.

Figure 02: GICS Sector breakdown of Deforestation engagements

Company engagements by sector

Number of company engagements in 2023



Source: Schroders, 2024.

Engagement insights

Through our engagements, we have identified several areas of weakness in companies' practices and approaches to managing deforestation risks and exposures, where we believe further action is needed.

- Many companies are relying on third party certification to address deforestation risk without investing in supply chain traceability and third-party assurance to provide robust verification of deforestation and conversion-free commodities, leaving them at risk of incomplete views of their supply chain exposures.
- Limited visibility into their supply chains leaves many companies challenged to meet forthcoming regulation in consumer markets. For example, the EU's Deforestation Regulation comes into effect in 2025, with companies facing fines of up to 4% of EU turnover for non-compliance, this significantly raises financial and investment risk for investee companies exposed to forest risk commodities in their supply chain. We have identified several companies that are at risk of material supply chain disruption and increased compliance costs.
- Smallholder farmers will require more support in the transition to deforestation-free supply chains. Collaboration is urgently needed between policymakers, investors, and agricultural representatives to establish incentive structures that enable smallholder farms to maintain their livelihoods, while transitioning to regenerative and sustainable agricultural practices.
- Embedded deforestation risk associated with soy is severely underappreciated and likely to grow as demand for soy-based animal feed continues to accelerate. A lack of consumer demand for deforestation-free soy has the potential to incentivise unsustainable land conversion practices in ecosystems such as the Cerrado in Brazil, with high conversation value and lower levels of international scrutiny.
- Companies need to take more meaningful action to integrate a consideration of human rights issues, such as land tenure and indigenous rights, into their deforestation risk management. Actions such as incorporating human rights impact assessments into deforestation due diligence programmes and enhancing transparency on the actions they are taking to implement credible grievance mechanism will help to prevent and mitigate human rights impacts.

Next steps – Monitoring and Escalation

In 2024, we plan to continue to monitor progress of our highest risk holdings, particularly with respect to growing investment and regulatory risk. We will aim to continue our engagements with the highest risk companies within our investment portfolio. We will continue to escalate these engagements where necessary in line with the escalation framework we have set out in our Engagement Blueprint[11], including through collaborative engagement initiatives and exercising our voting power where appropriate. We have joined Nature Action 100 and will aim to leverage our insights from our deforestation engagement in our wider biodiversity engagements.

We will work on establishing the foundations to integrate assessment of deforestation risk into our day-to-day investment activity beyond 2025. This should include developing the operational platform and governance process for reviewing our investment position in deforestation risk companies, leveraging our existing exclusions policies and processes. We also aim to develop a biodiversity metric that will seek to quantify deforestation risk and management, leveraging insights from the development of our deforestation scorecard and exposure analysis. On completion, we will look to integrate that analysis into established proprietary tools.

Finally, recognising the need for collaboration between companies, investors, and policymakers, we will also seek to use our influence in a wider range of asset classes, exploring opportunities to address deforestation risk through our sovereign and private market investments. For example, we will seek to scrutinise the publication of countries' National Strategy and Action plans to address biodiversity loss in the run up to UN's COP-16 biodiversity conference and engage with the UK's proposals for its own deforestation regulation.

Case Study – traceability and verification of 'Deforestation and Conversion Free' in Consumer Staples Companies

Over the last decade, there has been a significant focus on using certification, such as: Roundtable on Sustainable Palm Oil (RSPO) to demonstrate sustainable production of commodities. However, certifications vary in robustness, governance, and incentive structures and do not guarantee that products are deforestation free. Traceability to the farm or plantation of the forest risk commodity enables independent verification of Deforestation and Conversion Free (DCF) e.g. through satellite monitoring.

The EU's Deforestation Regulation shifts the focus from certification to traceability[12]. Companies are expected to demonstrate segregation of supply and precise timestamp and geolocation of production to support due diligence. These standards are proving extremely challenging for many companies as farm or plantation level traceability is rare. Companies that haven't invested in traceability systems face significant costs to adapt their supply chains at speed – one study, suggests a base case of 4.25% of EU spend, based on company disclosures[13].

Below we compare the current deforestation free status and traceability of three major Consumer Goods companies in our Tier 2 list of exposed companies, with significant purchasing of four forest risk commodities – timber; palm oil; soy and cocoa[14]. We have engaged with each of these companies in 2022 and 2023 through dialogue with their investor relations teams and sustainability specialists.

[11] schroders-engagement-blueprint.pdf.

[12] "In order to recognise good practice, certification or other third-party verified schemes could be used in the risk assessment procedure. They should not, however, substitute the operator's responsibility as regards due diligence.": EUR-Lex - 32023R1115 - EN - EUR-Lex (europa.eu).

[13] Barclays, European Consumer Staples Research, Seeing the Wood for the Trees.

[14] While the scope of our commitment focuses on palm oil, soy, timber, and beef, we have also been engaging with companies on deforestation risk for other high impact commodities such as cocoa, which will also be bought into the scope of the EU's Deforestation due diligence regulation.

Figure 03: Deforestation practice comparison across three Consumer Goods companies

	Sourcing volume (Metric tonnes)	Procurement spend	Revenue exposure	DCF status	DCF method
Timber					
Company A	1043614	1–5%	91–99%	95.58%	Gained through certification and independent verification.
Company B	1165000	1–5%	51–60%	99.90%	Gained through traceability to low-risk regions and on the ground assessment.
Company C	473834	6–10%	91–99%	99.00%	Gained through certification.
Palm oil					
Company A	778419	11–20%	51–60%	74.00%	Independent verification.
Company B	445000	1–5%	11–20%	95.60%	Traceability for high-risk regions, on the ground assessment and satellite monitoring.
Company C	126931	6–10%	21–30%	36.00%	Gained through certification
Soy					
Company A	312038	<1%	6–10%	92.40%	Traceability and independent verification and low risk region.
Company B	509000	1–5%	11–20%	99.30%	Traceable to low-risk region or certified or physical verified.
Company C	25855	1–5%	11–20%	0.00%	N/A
Cocoa					
Company A	66348	<1%	6–10%	0.00%	62% is certified through rainforest alliance – independent verification is taking place.
Company B	390000	6–10%	6–10%	0.00%	58% certified through rainforest alliance – independent verification is taking place.
Company C	2237	<1%	1–5%	0.00%	N/A

Source: Schroders, 2024; CDP Forest.

We can see that Company A and Company B are broadly on track to gain 100% DCF status by 2025 across timber, palm, and soy. Of concern is that all companies are significantly behind on assessing DCF status for cocoa. Company C is lagging its peers on achieving DCF status for all its commodities and appears to be relying on certification rather than traceability for verification of deforestation free. In 2024 we will focus on engaging with management teams on the robustness of their methodology for verifying DCF and continue to assess any associated supply chain volatility and revenue risk associated with the EU's deforestation due diligence regulations.

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