ESG Now Podcast

"The Fight Between Food and Forests"

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Bentley Kaplan:

Hello and welcome to the weekly edition of ESG Now, the show that explores how the environment, our society and corporate governance affects and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

And on today's show, we are going to get into the relationship between food and forests – how the production of specific commodities contributes to deforestation. And this relationship is nothing new. What is new is how the EU is planning to stop the sale of products that are linked to deforestation, and not in the distant future, but in the next couple of years. It might be a game changer for biodiversity, but it's also going to call on companies to step up their game. And for investors, there are going to be a few moving pieces to keep an eye on. Thanks for sticking around. Let's do this.

Now, humanity as a collective has seen a long and complex relationship between our food and the natural environment. And the former would of course never been possible without the latter, and arguably won't ever be possible. Like it or not, our food and biodiversity are stuck together like siblings on a long hot road trip. But the scale and growth of global food production has had increasingly negative effects on the environment. At this point, estimates suggests that food production is responsible for more than half of society's pressure on biodiversity. And that's through lots of different avenues like water consumption, eutrophication, the proliferation of pesticides, and even through climate change, which has been driven in part by large scale food production.

But on this episode, we're looking at one specific impact of food production on the environment, and that is deforestation. Because one of the key requirements to grow crops and raise livestock is space. And we are talking about big spaces here. Agriculture has been responsible for around 70% of global deforestation, and where it's really been prevalent is in tropical forests, where between 2010 and 2015 agricultural expansion has accounted for 85% of all deforestation.

And in the long term, maybe you could argue that eventually these chickens will come home to roost, and we'll realize just how much we depend on natural ecosystems in a Lorax-style story arc. But actually waiting for this lesson to be learned will of course have huge and negative consequences for society. So instead of waiting for things to get to this point, national governments and global

organizations like the UN are looking at different ways to slow or reverse deforestation, and biodiversity loss more broadly.

The EU is maybe on the leading edge of regulatory efforts here, and the example we are going to be talking about today is the EU's regulation on deforestation-free supply chains, which was first proposed in November 2021, and was signed into law in June just a couple of months ago. It's legislation that has the potential to impact many different companies and industries, but today we are going to be talking about how it's going to affect food production, one of the main contributors to deforestation.

And to do that, I've got Cole Martin out of our London office. And first up, Cole gave me the cheat sheet on this new regulation.

Cole Martin:

So basically the EU has passed a law requiring companies that are importing certain commodities into the bloc to prove via a due diligence process that those commodities did not come from deforested land. And those commodities include beef, soybean, palm oil, cocoa, and coffee, as well as timber, and any derivative products that come from those. And if you are unable to prove that or you violate the law in some other way, you as a company are at risk of fines or confiscations, and those fines are up to 4% of your revenues in the member state that catches you violating the law.

The way the law is going to work in practice is that the EU is going to create a benchmarking system and rank countries where these commodities are produced as either high, medium, or low risk of deforestation. And if you are going to be importing those commodities from a higher risk country, you are in theory going to have a more stringent due diligence process that you have to follow. And one of the implications of this is that the EU is basically encouraging companies to import these commodities from countries that are at lower risk of deforestation.

Bentley Kaplan:

Right. So the EU has already identified what types of commodities have been linked to deforestation, and it's the usual suspects, like palm oil, which has seen huge areas of tropical forest cleared for plantations, and the same goes for cocoa or soy or beef or timber, but then also the products that rely on these raw materials like chocolate from cocoa or leather from beef farming.

Companies are also expected to know where their products are coming from, as in point to it on a map. And those areas they're pointing to will need to be free from deforestation, whether or not that deforestation is happening legally. And based on that, it's clear that this regulation is not going to affect all companies equally.

So next, I asked Cole about some initial considerations that some companies might be having, and how it might ask some initial questions about supply chain traceability.

Cole Martin:

I mean, in theory, any company that is importing these commodities into the bloc, regardless of where they're domiciled, could be impacted by this law. So I'll give you an example of how this could work in practice. Let's say you're a company that makes chocolate. You could be a company that therefore has to import cocoa as well as palm oil to put into your chocolate bar.

One of the issues around this could be, for example, that let's say you're importing your cocoa from West Africa, when countries in West Africa could end up potentially as higher risk countries for deforestation. And let's say you decide instead of importing from West Africa, let's say you decide to get your cocoa from somewhere else, let's say Ecuador, because they may be a lower risk. One of the issues with cocoa, for example, is that it has something of a terroir in so far as the soil conditions and the microclimate can affect the flavor profile of the bean. And so if you're importing cocoa from somewhere else and then you import that cocoa into Europe and then apply the sugar and the milk and whatnot, as part of the manufacturing process, you could have a chocolate bar that actually tastes different. So you as a company therefore might have to spend money to either change your product formulation at the manufacturing stage, or potentially spending more money in R&D. And so that could be a situation where changing the imports of your commodity could have actual financial consequences.

One of the key elements of the regulation is that companies will have to provide the precise geolocated coordinates of where the commodities were produced. And so one of the possible implications of that could be that, depending on what commodity you're talking about, which geolocated coordinates the EU will ask for might vary. So for example, because traceability levels for palm oil might be a little bit higher than for beef or for cocoa, the level of traceability required for palm oil could be all the way to plantation level. Whereas for beef, it could be to, for example, the state where the cattle was processed or the state where the feedlot location is.

Bentley Kaplan:

Right. So this new regulation is introducing this idea of precise geolocations. Now, a caveat that Cole mentioned in our full recorded interview is that the regulation is mentioning where a specific commodity is produced, which could mean a few different things depending on what commodity you're looking at. But regardless, what is clear is that knowing where your commodity is coming from is going to become a lot more important. And knowing that, as Cole points out, can be tricky.

I mean, imagine you're standing in a forest where trees are being chopped down to make room for something like a palm plantation. Because the palm fruit from that plantation could follow many different routes once it's harvested. I mean, first it goes via mills and distributors and into initial products, like palm oil, or bakery fats, stearins, or fatty acid distillates, which are in turn used to make things like ice cream and biscuits and cake mixes and margarines and detergents, and the list goes on. Now, imagine you're a company standing at the end of the supply chain. The longer the route that palm fruit takes to the product you're depending on, the harder it's going to be to trace it backwards and prove you're not linked to deforestation. So if you're a company at the end of a complex supply chain, you're really going to need to bring your A-game.

And with this idea of the EU's regulation on deforestation-free supply chains affecting different companies in different ways, Cole looked into how this actually might play out. And there are two parts to this. The first being characteristics, like where your commodity comes from, what commodities you rely on, and how well you can trace them. And the second part is how all of these interact to create more or less financial risk for companies. And first, Cole took me through the characteristics of commodities.

Cole Martin:

So what we wanted to do was create a framework to assess which companies might face the most significant financial challenges relative to peers in aligning to the regulation. And this was essentially a four-part process. The first is we looked at how much exposure the company has to the EU, because the fines are going to be based on a percentage of revenue. We wanted to look at the exposure to the particular commodities, so how much revenue a company derives based on the commodities in question, and that relies on some of our proprietary revenue reliance data. We then wanted to look at current levels of traceability by a company in terms of what they disclose. Theoretically, if your current levels of traceability are higher, you'll have less work to do to align to the regulation.

And then finally, we wanted to think about what could be the financial implications for companies that are exposed to the EU, have some degree of reliance on these commodities, and may not have a hundred percent levels of traceability right now.

Bentley Kaplan:

Okay. So with these attributes in mind, Cole analyzed about 90 global food companies to see where they landed across a mini matrix in terms of their reliance on specific commodities, EU revenue, and the extent to which they currently trace their supply chains. Now, where this analysis might really make companies and investors sit up and take notice if they haven't done so already, is how these different aspects might translate into financial risks, both in terms of how much due diligence would be required, based on what commodities and areas a company depends on, but also in terms of how easily a company might be able to weather these impacts. Here's Cole.

Cole Martin:

When it comes to thinking about the financial implications, our approach was essentially to group the costs of aligning to the regulation into two buckets – the direct costs and the indirect costs of aligning to the regulation. And then ultimately think about what could be the impact on a company's free cash flow.

So if we think about the direct costs first, these are essentially the administrative costs of aligning to the regulation. So these are the costs of hiring a couple of people to do the paperwork and then send that paperwork away, more or less. And the EU has actually provided an estimate for how much this will cost companies across the entire block, and they put a number somewhere between 200 million and €2 billion annually.

But if you think about how large the food industry is within the EU, it's worth roughly €1 trillion annually. And so these direct costs really aren't that significant from an individual company perspective. What the EU did not quantify, are the indirect costs of lying to the regulation. So that could include things like reorganizing supply chains, accepting higher costs from suppliers, the threat of fines or confiscations from the EU, or potentially even reducing EU operating exposure.

Now, some of these costs could fall into operating cash flow, so things like fines and confiscations. And some of these costs could be split between operating and investing cash flow. So that's things, for example, like setting up new leases or building new manufacturing facilities in different countries.

So we decided to use free cashflow because the value of these indirect alignment costs could be split somewhere between investing and operating cashflow. I don't know necessarily where they will fall, but they will affect at least one part of that equation one way or the other. And so what we decided to do was measure companies’ exposure to the indirect costs, as well as the companies’ capacity to mitigate these indirect costs. And so when we add all those together, we look at EU exposure, commodity exposure, traceability, and the exposure and management of those indirect costs, we manage to get a picture of which companies we think may face the most significant financial alignment challenges relative to peers.

Bentley Kaplan:

Okay. So with any regulation, there are going to be some unavoidable marginal costs. You need warm bodies to draft new reports and submissions, but these aren't going to break the bank, as Cole tells it. Where things are going to get a lot more hazy is when you dig into how this new law is going to cause operational changes, things like reorganizing your supply chain, taking a hit from a supplier that has better tracing programs, or even building new facilities, shifting sales outside of the EU, or if you just can't get things together in time, having to pay a fine of up to 4% of annual turnover.

Those costs are going to differ from company to company. And for investors, this is really where the conversation begins in earnest. In a virtual checklist, you're figuring out, one, how much does a company rely on sales in the EU? And two, of those sales, how many are tied to commodities that are intertwined with deforestation? And once you have that, you look at how well a company can trace its commodity supply chain. Do they really know where the stuff is coming from? And if they do, well, maybe you're in a good spot. But if not, then it becomes about where these direct and indirect costs are going to materialize.

And Cole found that free cash flow is a helpful starting point because it is at least part of where companies are going to feel the pinch. And this is the lens that Cole used to look at these 90 global food companies. And while I'm not going to call out specific companies, of the five that faced the biggest regulatory alignment challenge, there was no one commodity that dominated, with beef, cocoa, and palm oil all featuring.

Which in some ways is fitting, because deforestation is not tied to any single commodity. In preparing its most recent law on deforestation, EU regulators have cast a wide and ambitious net over the food industry. And it's probably going to take some rolling up of the proverbial sleeves and a much deeper look at supply chains if companies are aiming to meet this rising standard.

And that is it for the week. A massive thanks to Cole for his take on the news with an ESG twist. And thank you very much for tuning in. It is always a privilege to be able to put this content together, and to sprinkle some ESG spices over your podcast buffet, poke bowl, and/or tapas, depending on what strikes your fancy. Just a quick heads up that we will be taking the next couple of weeks off to work on some ideas for the last few months of 2023, and to get some dust out of our mixers and off our microphones. We'll catch you again at the end of August, and until then, please do take care of yourselves and those around you.

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