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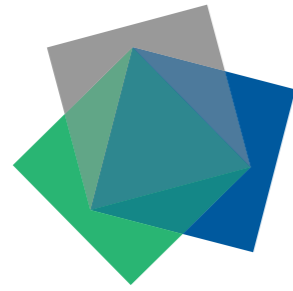
SEP 2010

PALM OIL IN ASIA

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Glossary

The following is a selection of the acronyms and terms used in the palm oil industry:

CDM	Clean Development Mechanism
CPO	Crude Palm Oil
EFB	Empty Fruit Bunch
FAME	Fatty Acid Methyl Ester (biodiesel)
FELDA	Federal Land Development Authority
FFA	Free Fatty Acids
FFB	Fresh Fruit Bunch
GAPKI	Indonesian Palm Oil Association (Gabungan Pengusaha Kelapa Sawit Indonesia)
IOPRI	Indonesian Oil Palm Research Institute (Pusat Penelitian Kelapa Sawit)
IPOC	Indonesian Palm Oil Commission
MPOA	Malaysian Palm Oil Association
MPOB	Malaysian Palm Oil Board
MPOC	Malaysian Palm Oil Council
Olein	The liquid fraction of palm oil
PKO	Palm Kernel Oil
POM	Palm Oil Mill
POME	Palm Oil Mill Effluent
PORIM	Palm Oil Research Institute of Malaysia
RBDO	Refined Bleached Deodorised Oil
RSPO	Roundtable for Sustainable Palm Oil
Stearin	The solid fraction of palm oil

With grateful thanks to the contributions and support of:

Sophie Le Clue, ADM Capital Foundation
Masya Spek, Investment Consultant, Hanacaraka
Olivia Watson, Principles of Responsible
Investment
Simon Wilson, Thomson Reuters
Melissa Ong, Director, Responsible Research
David Fogarty, Thomson Reuters
Hristo Guertchev, Thomson Reuters
Cherie Tan, WWF, Singapore
Mark Mills, Generation Investment Management

EXECUTIVE SUMMARY

This report provides an overview of the environmental, social and governance (ESG) issues in the palm oil sector. The issues we highlight are those we view as the most material for companies and which pose the biggest threats to their operations, brands, reputation, profitability and shareholders. The non-financial risks involved in the sector can be broken down into physical, regulatory, structural and reputational in nature. While the palm oil sector remains an attractive investment candidate with high potential for growth and returns, responsible investors need to clearly understand the potential pitfalls regarding the industry's development.

Palm oil is the edible oil derived from the African oil palm (*Elaeis guineensis*), which thrives in the tropics and is the world's most productive commercial oil seed. The oil is used in a range of consumer goods from processed foods, shampoos and cosmetics to biodiesel. It can be found in approximately ten percent of all products in European supermarkets.² Production in Asia is largely based in Malaysia and Indonesia with over 80 percent of global production coming from these two countries. Both countries view the industry as a cornerstone of economic development and a key to eradicating poverty. Many firms are attempting to navigate emerging government and buyer regulations and local law enforcement practices. Skills and abilities are often lacking on the ground, leading to a rather chequered performance by the industry in terms of ESG performance.

Demand for palm oil has risen globally for many reasons. It is a low-cost food and biofuel oil with high yields relative to other vegetable fats. Once processed, the oil has very little taste and is easily transported in its liquid form. Being so inexpensive to produce, it is now seen as a tool for the sustainable development of many developing countries with food security challenges, especially China and India, resulting in high levels of investment in the sector.

The debate is still raging however on the long-term sustainability of the industry. The oil's reputation as a healthy, no trans-fat alternative to traditional hydrogenated and partially hydrogenated vegetable oil is now in question due to the high levels of saturated fat in palm kernel oil and the links between palmitic (saturated) acid and heart disease. Conversely red palm oil has been studied for its high level of nutrients and it is seen as a possible weapon in the treatment for breast cancer.³

More controversially still is its new prime position in tropical natural ecosystems, which has resulted in a devastating loss of some of the world's most precious rainforest. The plantation companies who have benefited from the growth in demand are now blamed as culprits of mass deforestation in Asia and, therefore, climate change. Palm oil producers are frequently accused of illegally cutting down natural rainforests, developing on peatland (a key carbon sink) and threatening many endangered species. Plantations have in the past also been found practicing open burning, which contributes to the dirty haze that occasionally hangs across parts of Southeast Asia.

Other issues that affect the sustainability of the industry are social in nature and include workers' rights and land disputes. A serious concern is worker health. Plantation labour is generally poorly paid and exposes workers to hazardous chemicals that are banned in most parts of the world but continue to be used in Malaysia and Indonesia. In particular the notorious herbicide, paraquat, is used on palm oil plantations to control weeds even though it is known to cause devastating health effects on workers. Land disputes often coincide with plantation expansion, particularly in Borneo, which covers the Indonesian state of Kalimantan and the Malaysian states of Sarawak and Sabah. Numerous local indigenous groups are involved in lengthy land disputes and court cases over native customary land rights.

In response to the sustainability risks in the palm oil supply chain, producers have begun to actively engage with organizations such as the Roundtable on Sustainable Palm Oil (RSPO), a multi-stakeholder initiative aimed at addressing the environmental and social problems of the industry. RSPO-certified palm oil is subject to ESG guidelines that go beyond the current levels of national

legislation. However, lapses in compliance have occurred and many people are still concerned with the effectiveness of the certification system as well as the implementation, enforcement and auditing of RSPO's Principles and Criteria.

Corporate governance in the sector has depended largely on whether companies are publicly listed entities and, if so, what are the mandatory reporting requirements of the stock exchanges. The Singapore Stock Exchange has a reputation of being one of the most diligent Asian bourses in terms of corporate governance, yet there are some producers listed in Singapore whose governance disclosures are not transparent enough to comfort minority investors that their interests would be protected.

While governance issues are important, most Asian investors are not as concerned with identifying environmental and social risks to their investments. Negative reputational impacts tend to arise locally only if corruption is involved, but are usually quickly forgotten; hence many companies experience little pressure to change. However, increased global scrutiny on the palm oil industry may force companies to address environmental and social issues sooner than planned.

The report also includes a benchmarking analysis of some of the top 14 palm oil companies based on Asian Sustainability Rating™ (ASR™) criteria. Each company is ranked based on publicly available information according to key performance indicators in the following areas: General, Environmental, Social (including Employees, Consumers, Suppliers and Community) and Corporate Governance. Companies were then assessed against palm oil-specific criteria and scores in all four areas were used to arrive at the final rankings.

The data show that the leading four companies are New Britain Palm Oil, Kulim, United Plantations and Wilmar. These are the plantation companies we have identified as future leaders due to their current understanding of the matters at hand and willingness to engage with stakeholders on sustainability issues that will affect the industry going forward.

Figure 1: The ASR™ Palm Oil Universe showing leader

	MARKET CAP (US\$M AS OF 20 SEPT, 2010)	PLANTATION LAND (HA) AS OF DEC. 2009	ESTIMATED NUMBER OF EMPLOYEES	SIGNIFICANT FAMILY OWNERSHIP	RANKING IN ASR™
NEW BRITAIN PALM OIL (NBPO:LN)	1,335	40,009	8,920		1ST
GENTING PLANTATIONS (GENP:MK)	1,853	60,007	5,695	LIM	NOT DISCLOSED – RANKINGS GIVEN IN FULL REPORT
GOLDEN AGRI RESOURCES (GGR:SP)	5,269	433,200	31,448	OEI/WIDJAJA	
HAP SENG PLANTATION RESOURCES (HAPL:MK)	606	34,381	5,419	LAU	
INDOFOOD AGRI RESOURCES (IFAR:SP)	2,449	193,613	29,400	SALIM	
IOI CORP.(IOI:MK)	12,049	251,000	27,329	LEE	
KL KEPONG (KLK:MK)	5,881	243,000	25,000	LEE	
KULIM (KUL:MK)	844	151,899	24,607		
PT ASTRA AGRO (AALI:IJ)	3,621	264,036	24,556	SOERYADHAYA	
PT BAKRIE SUMATERA (UNSP:IJ)	531	80,000	14,227	BAKRIE	
SAMPOERNA (SGRO:IJ)	568	90,000	4,426	SAMPOERNA	
SIME DARBY (SIME:MK)	15,781	540,000	100,000		
UNITED PLANTATIONS (UPL:MK)	1,032	31,502	7,029	BEK- NIELSEN	
WILMAR INTERNATIONAL (WIL:SP)	30,529	235,000	80,000	KUOK	

KEY FINDINGS

1 Global demand for palm oil will continue to rise. Oil palm-derived edible oils now make up 36 percent of global edible oil consumption, up from 22 percent in 1999. It has been estimated that demand for palm oil will double by 2020.⁴ In comparison, soybean oil provides 29 percent of global edible oil, rapeseed 14 percent and sunflower 8 percent. Taken together, peanut, cottonseed, coconut and olive oils account for 13 percent of global consumption.

The rapid growth in demand is expected to continue as the global appetite for oils and fats grows with increased consumption of processed foods, cosmetics and other products. To keep up with demand, the production of palm, soybean, rapeseed and sunflower oils has increased dramatically while production of other edible oils has remained relatively constant.

Increased demand for palm oil as an ingredient for consumer products is compounded by legislation by a number of countries that requires the increased use of blended biodiesels. Palm oil is a key candidate as a biofuel feedstock, and its high yields and ease of production make it a cheap and plentiful fuel source.

2 Investors, business groups and civil society will increasingly challenge the issue of sustainable palm oil production. Palm oil has been the target of environmental campaigns and consumer boycotts due to its impact on old growth rainforests and wildlife habitats. The response from investors, business groups and civil society has already led companies to implement sustainability initiatives and engage with industry organizations. This is expected to increase with growing public concern and awareness of the urgency of the environmental issues involved.

Some of the issues that prompt responsible investors to question and pressure the industry include the clearing of land in some of the world's most biodiverse regions to make way for monoculture plantations as well as mounting concerns over greenhouse gas (GHG) emissions. Threats against endangered species, such as the orangutan and Sumatran tiger, are also blamed on the increasing prevalence of palm oil plantations in these unique tropical habitats.

Land clearing is also associated with climate change as plantations are often situated on peatland and natural forests, which have been identified as valuable carbon sinks. Slash-and-burn agriculture further releases air-borne particulates into the atmosphere, regularly shrouding much of Southeast Asia in a dirty haze. This matter released by open burning has been linked to respiratory and heart disease and is a major public health concern when it occurs.

3 Oil palm is the highest yielding oil crop in the world and is seen by many as essential to satisfy future demand for calorific intake. The oil palm yields approximately 6,000 litres of oil per hectare of harvested land. In comparison, rapeseed yields 1,190 litres, sunflower yields 952 and soybean yields 446. As global demand for edible oil continues to increase, palm oil may prove to be the most sustainable source as it requires less cultivated land to produce equal amounts of oil.

Research and development on yield enhancement is a key to the future sustainability of the industry. High levels of investment in this area means palm oil will likely remain the world's most efficient and in-demand oil crop.

4 The Roundtable on Sustainable Palm Oil (RSPO) will strengthen in response to calls for sustainable production and supply. The RSPO was set up in 2004 in response to consumer and buyer demands for sustainably produced palm oil. It is a non-profit group that aims to create a set of working criteria for all stakeholders, including growers, processors, buyers, investors and non-governmental organizations (NGOs). RSPO has certified 71 sustainable palm oil mills in Malaysia, Indonesia, the Solomon Islands and Papua New Guinea that produce over two million tonnes of palm oil and palm kernel oil a year, just over four percent of the global total. The Principles and Criteria of the RSPO are expected to continue to evolve and provide guidelines for the industry and companies will be required to implement the necessary changes to achieve certification.

5 The palm oil industry will continue to be an integral part of economic growth and poverty alleviation in both Indonesia and Malaysia. Both the Indonesian and Malaysian governments see the palm oil industry as a driver for economic growth and a key to poverty alleviation in rural areas and remote states. To this end, both governments offer generous incentives to investors in the sector as well as lenient land-use policies.

The Indonesian and Malaysian governments both run programmes offering small parcels of land to the poor for cultivation, forming a vital role in poverty alleviation strategies. That said, the land parcels are often areas of uncleared forest and are likely to have much lower yields than large plantations, lacking resources for yield improvement, research and development.

6 Palm oil companies will become more aware of environmental issues and improve their management and reporting. In recent years, Malaysian companies have led the way in improving the sustainability of oil palm cultivation. Research and development into increasing yields without expanding cultivation into new land has been a key to this strategy. Some companies have included sustainable practices such as composting empty fruit bunches and breeding owls for natural pest control. Unfortunately, pressure to eliminate slash-and-burn techniques has not been entirely successful and has led to increased chemical use in some cases. Many companies have resorted to public relations 'green-washing' in public communications, while others refuse to report on GHG emissions and other key environmental performance indicators. As consumer demands and certification standards mature, palm oil companies will be required to comply with stricter environmental operating requirements.

7 Analysts and portfolio managers will require broader, deeper and more reliable data to gauge the sustainability of operations of palm oil plantations. As environmental reporting moves to the mainstream, palm oil companies will be expected to provide consistent data on key performance indicators. The Global Reporting Initiative (GRI) recently released supplemental guidelines for the food processing industry, highlighting the demand for comprehensive data in areas such as sourcing, purchasing policies under responsible product standards, clear labelling of environmental and social information, and labour practices. In August 2010, the Singapore Stock Exchange also released guidelines on reporting to encourage listed companies to improve disclosure on sustainability practices. Though the Singapore Stock Exchange guidelines are not yet mandatory, they do represent a movement towards increased demand for environmental reporting.⁵

To date, some palm oil companies have voluntarily reported partially on their ESG performance while most have remained painfully silent. Our analysis found that while all 14 companies covered in this report had some form of ESG reporting, the quality and content of the individual reports varied greatly. Benchmarking and certification by RSPO and WWF will make more of this data available, providing a common base for comparison. Demand for independent assessment consultants such as AidEnvironment will grow, alongside the need to verify data on the ground.

8 Consumers will increasingly demand sustainably-sourced palm oil and visibility over provenance. Consumer boycotts and environmental campaigns have focused upon the industry in recent months, which has put pressure on companies such as Unilever and Nestlé to purchase from sustainable sources of palm oil. This in turn places more pressure on producers to gain sustainability certifications to sell their products on the global market. Many companies have committed to 'responsible' palm oil sourcing and have timelines for converting entirely to certified sustainable palm oil.

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