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PSA BRIEF:

Due Diligence on Agricultural Suppliers

Mitigating third-party, ESG, and supply chain risks

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Agricultural suppliers can be considered high risks for environmental, human rights, and labor issues. They often operate in low-information environments, where facts on the ground are challenging to confirm. This combination of high-risks and high-uncertainty means companies relying on or investing in agricultural suppliers need to adopt flexible risk management systems.

Many companies operating in the agriculture sector seek to align their policies with sustainability best practices like the OECD/FAO Guidance for Responsible Agricultural Supply Chains. Others have a similar set of concerns connected to an ESG framework or the Principles for Sustainable Investment. Many enterprises view risk through the lens of their TPRM programs focused on corruption, fraud, and operational and reputational risks. Whatever the scope of a company's risk management program, the potentially severe sustainability and corporate governance issues presented by agricultural enterprises demand a robust risk management process.

Unique Reputational Risks

When it comes to environmental issues and human rights, many consumers hold multinational companies responsible for their entire supply chains. The case of Thai food giant Charoen Pokphand Foods (CFP) illustrates how easily upstream risks can flow all the way down to the retail level. CPF's farmed prawns were fed fish meal sourced from various suppliers, some of whom allegedly used slave labor on their boats. After investigative journalists uncovered these allegations, the damage spread far beyond CPF to its major customers, even resulting in a lawsuit against a US retailer for selling CPF products.

Singaporean food company Wilmar International provides another example. Significant negative media and criticism from NGOs about its palm oil plantation partners in Indonesia led to reputational problems for its many multinational food company customers.

Both cases present the same dynamic, with problematic suppliers operating in poorly governed spaces and low-information environments where vetting suppliers is challenging. Yet despite these challenges, in both cases journalists and NGOs were able to credibly document significant problems in the supply chain and widely publicize them. By gathering critical information early in a business relationship, an effective due diligence program shifts the stance of a risk management program from reacting to problems to proactively mitigating them.

Key Concern: Sustainability Risks

The agriculture sector presents numerous challenges when it comes to sustainability. Regardless of whether sustainability concerns are organized around ESG principles or reputational factors, global agricultural supply or investment chains must be carefully evaluated for their significant inherent risks. These risks are very real: in PSA's more than 20 years of conducting due diligence, it has identified cases involving all of the following issues.

Slavery

Combatting modern slavery is a growing compliance priority. The UK, California, and Australia have all implemented supply chain reporting requirements. The EU and the US are set to advance legislation in 2021 that may prescribe due diligence measures for identifying slavery and other human rights issues in the supply chain. Due diligence can be an important tool in closing the gaps in reporting systems currently driven largely by self-disclosure. In a recent engagement, PSA learned of a farm deep in the Amazon that was under investigation by local authorities after an escaped laborer alleged it was operated by slaves.

Child Labor

Emergin regulations addressing slavery in the supply chain are likely to cover the worst forms of child labor. In PSA's experience, allegations of child labor made against agricultural companies are common on several continents. The ILO estimates that 60% of the word's child laborers work in agriculture—nearly 100 million children.

Other Labor Issues

Adverse issues that PSA frequently encounters with agricultural suppliers include exposure of workers to dangerous equipment or harmful chemicals, uncompensated overtime, poor worker accommodations, and violent responses to labor protests that sometimes involve the co-opting of local authorities. The prevalence of migrant workers in agriculture increases risks of human rights violations, particularly at the beginning of supply chains.

Land Tenure Issues

A significant share of the world's agricultural production is located in areas with poor governance regarding property rights and land use. Weak rule of law and ambiguous or historically unsettled land rights can lead to contested ownership of agricultural land, disputes involving the rights of indigenous peoples, and unwanted political interference. In a recent engagement in South America, PSA encountered allegations that an agricultural company had illegally appropriated land reserved for an indigenous group but had legalized its claim through a corrupt arrangement with a local judge.

Environmental Degradation

Environmental harm and unsustainable use of resources are inherent risks in agricultural production. It is normal for most agricultural enterprises to have a proportionately higher environmental impact than many companies, but material sustainability risks must be effectively distinguished. The recent case of Harvard Management Company (HMC) demonstrates how even the best intentions can be undermined by distant investment partners. HMC, which handles the university's endowment and was the first university body to sign the Principles for Sustainable Investment, faced calls from the university's student body to divest from its holdings in Brazilian agricultural land due to deforestation and other significant issues with its local counterparty.

Impacts of Corruption: FCPA Risk and Beyond

One of the most common focuses of third-party due diligence is FCPA risk, usually presented by third parties paying bribes to public officials to secure contracts or obtain approvals. US regulators' enforcement patterns do not indicate an unusual risk of such practices among agriculture companies compared with those in sectors like oil & gas or healthcare. However, in some jurisdictions, larger suppliers and processors can present high corruption risks. Even in engagements where FCPA risks do not directly apply, it is important to be wary of any indication of unethical behavior by a counterparty. Failures in a company's internal controls or culture can lead to significant operational and reputational risks, and local corruption enforcement activities can result in large penalties in their own right. The cases of two Brazilian agriculture companies, BRF and J&F Investimentos demonstrate how patterns of corrupt behavior can metastasize into critical operational and reputational problems.

In 2017 Brazilian authorities announced an inquiry, "Operation Weak Flesh," into claims that several companies, including food production giants BRF and J&F's subsidiary JBS, were bribing inspectors to overlook health and product quality violations. BRF announced it had responded to US DOJ information requests, and an FCPA investigation is reportedly ongoing. More importantly, the Brazilian investigation led to numerous problems for BRF, including criminal charges against its executives, export bans, an investor lawsuit, and financial penalties affecting shareholder value.

J&F's problems go far beyond the Weak Flesh investigation. In October 2020, J&F pleaded guilty and entered into agreements with the DOJ and SEC to resolve FCPA violations, concluding an investigation that had held up subsidiary JBS's US share listing. J&F allegedly bribed numerous officials at Brazilian state-owned financial institutions in order to secure financing, including to facilitate its acquisition of US poultry producer Pilgrim's Pride. While the US government's initial sanctions against J&F were a considerable $285 million, total Brazilian government sanctions amounted to $1.8 billion.

Fit-for-Purpose Due Diligence Options

In any industry—not least in the agriculture sector—the practice of "trust but verify" is preferable to a risk management approach based solely on self-disclosure. Independent due diligence into counterparties offers the most direct route to such verification and is also an important tool for providing context and weighting risks based on counterparty location.

Resources can be appropriately allocated through a risk-based approach, and due diligence methods can be scaled accordingly. For low-risk or low value engagements, desktop research can focus on keyword searches and review of official documents. More intensive approaches can include discreetly gathering commentary from informed human sources such as local NGO leaders, former employees, and government regulators. Further options can involve site visits to production locations, or more investigative steps to evaluate specific allegations of misconduct.

As regulators require more action on sustainability, and ESG continues to grow as a key consideration in investment decisions, it is important to ensure diligence methodologies are adequately designed to capture an expanding set of risk factors.

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