Forestry Investments in Emerging Markets

Business risks and opportunities to invest in the forest sector

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Background and objectives

Investments in forestry have many desirable features. Under certain conditions, forestry investments yield attractive returns to investors and can contribute substantially to the economic, social and environmental development of countries. Environmentally and socially conscious investors are actively exploring the "ins and outs" of forestry opportunities, motivated by opportunities that are profitable, but also in line with their core values.

Between the 17th and 19th of May 2011, about *50 participants* attended the meeting "Forestry Investments in Emerging Markets." About one third of the participants were socially and environmentally conscious investors and investment advisors. Another one third of the participants jointly represented 17 investment opportunities in the tropical hemisphere, together worth over 95 million of investments in responsible forestry. The meeting took place in the Netherlands, a country with significant expertise in tropical forestry and a history of public and private investment in forestry in developing countries. The meeting was organized by FAO, the NFP Facility and Tropenbos International with support of the Business in Development (BID) Network, and the Ministry of Economic Affairs, Agriculture and Innovation of the Netherlands. The meeting was attended by institutional investors, investment advisors, timber funds, forest business developers, and forestry specialists. Selected NFP Facility partner countries attended the meeting. Participants from these countries included forest finance professionals that have worked domestically to identify promising business opportunities.

Objectives of the meetings were to:

(1) Share perspectives on challenges and opportunities regarding the greater involvement of investors in forestry (REDD+, biodiversity, forestry) in emerging markets
(2) Showcase and discuss a variety of forestry-based business cases and fund structures as a basis to better understand the requirements and potential of such business cases and for collaborative work between potential investors and promising forest business initiatives in emerging markets.
(3) Contribute to an action plan to narrow the gap between investors and forestry opportunities.

The interactive programme - consisting of plenary, panel and group sessions – provided and informal platform for exchange and engagement among participants. Seventeen business *fact sheets* from seven countries provided the basis to discuss in concrete terms the risks and opportunities to invest in forestry in emerging and frontier markets. The cases included plantation forestry, natural forest management, processing and alternative businesses. In addition, several participants shared short notes on their work, which were contained in the *information package.*

Key observations

The following key observations were identified and discussed regarding:

- Business case development and marketing
- Management capacity of forest enterprises
- Investor types and requirements
- Investment fund design and financing,
- Payments for environmental services, and
- Narrowing the gap between forest and finance sectors.

Business case development and marketing

Business plans contain the basic information that allows investors to pass a first judgment on the project proposition seeking finance. Weak capacity to develop such plans, inadequate knowledge, and a history of forestry seen as resource extraction (not as a sustainable business if properly managed) means that comparatively few forestry enterprises have the capacity, the information and the records to approach and engage an interested and therefore, inquisitive investor. Five "must have" aspects of business case development were mentioned, including:

- **Appropriate scale**. Different types of investors need different scales. For institutional investors such as pension funds, development banks, or insurance companies due diligence must be carried out. Such due diligence imposes a significant fixed cost (~$100,000). Therefore, it makes sense to carry it out only for projects of a minimum size. Specialized expertise (something that investors need) is also often necessary and becomes "affordable" (or justified) only for projects of a certain size. These are some of the reasons why institutional investors will usually consider only projects of a certain size. However, while some scale is needed to justify transaction costs and overheads, bigger is not necessarily better in terms of financial returns. "Back casting[1]" was mentioned as is a useful approach to determine the optimal scale. Using backcasting, business

[1] Wikipedia defines it in this way: "Backcasting starts with defining a desirable future and then works backwards to identify policies and programs that will connect the future to the present. The fundamental question of backcasting asks: "if we want to attain a certain goal, what actions must be taken to get there?"

developers will ask: What do you need in terms of returns to make the business sustainable? And design the business case on the basis of that notion, rather than let the scale determine the returns. Smaller projects need alternative mechanisms to guarantee “trust and confidence” between the investor and the project. Some of these alternative mechanisms were discussed, such as “filtering and matchmaking” services (e.g., the ones provided by FAST, BID Network, or other intermediaries), “soft” investments in human resources and institutions, among others.

- **Track record**. Business plans are a promise. Will this promise be fulfilled? Finance and investment experts mentioned that, in evaluating a business proposition, investors will look at the “track record” of the country, of the enterprise (e.g., historic performance in terms of management competencies, planning, implementation and financials), and of the product. This is an area where forestry enterprises are often weak: business records are not kept; understanding of the market and of competition is incomplete; and project information is often asymmetric. Need was mentioned for “business incubators,” organizations and efforts aimed at building entrepreneurial capacity and a “credit history” of some kind. The more “sketchy” the track record, the more risky the proposition will be perceived, which translates into a higher cost of capital. Project proponents will,, in many cases, act as country “ambassadors” to project a good image of the country. Engagement with an established international partner can also be very effective to build the credibility needed to enter new markets. In these regards, the role of organizations like BID Network or national agencies as the Forest Finance Intelligence Unit of Guatemala is instrumental to identify the most solid and promising opportunities and to provide them with the adequate enterprise development coaching and support.

- **Return rates**. The return rates that can be obtained via good forestry are attractive (reaching 10-18% under certain conditions). Their presentation in the business cases have to be reasonable. If too low, they are not attractive; If too high, they raise suspicion of being a scam or very risky. There is a correlation between risks and expected returns. Risk factors need to be clearly identified in the business case, along with strategies to manage and mitigate them. The savvy investor will also ask for the sensitivity of these results to various parameters such as price changes, biological growth, and other sources of uncertainty. Business developers should understand, and be able to present, the risk profile of their projects.

- **Exit strategy**. A discussion point was also the importance of being able to provide investors with the opportunity to cash in on their investments when needed. For this, a possibility is the creation of a secondary market like the issuing of forest-backed securities.

- **Legal issues and investment security**. Another topic of discussion was the importance to understand project risks and to have a strategy to manage them. Well known sources of project risk include land tenure and political instability. Security concerns also affect the investment mechanisms themselves. Any investment mechanism (e.g., a timberland investment fund) will involve a number of legal issues. Therefore, an important consideration in the establishment of an investment mechanism is under which laws will the mechanism operate. This is one of the reasons why investors will prefer to invest or operate a fund that is registered in a country with a familiar legal structure (this explains why so many funds operate out of the Bahamas, or Caiman Islands, for example). Lack of knowledge and familiarity increases the perception of risk. For example, an investor with prior knowledge of a developing country may consider it less risky than an investor that does not have such knowledge.

Participants furthered identified the need for capacity building support and coaching for the development of bankable business, the need for good standards, reliable figures and support tools for developing business cases, and the need to engage expertise that act as the devil's advocate; in particular to assess and qualify uncertainties and risks. Most projects do not end up in the "major league", not because of the opportunities, but because they fail to properly identify and qualify the risks and the revenue and cost streams and to start from the market reality (start from the "tail end"). Capacity building is also needed for financiers/banks in the country themselves to help them better understand the nature of the forestry business. Finally, participants identified clearly the need for events like this one where investors and investment advisors can meet with project developers.

Management capacity, efficiency, and reputation

One of the most critical issues mentioned during the event related to the management capacity of forestry businesses. In general, forestry businesses are plagued by a rather low management capacity and low operational/technological efficiency. Anecdotal evidence was shared that successful forestry enterprises often have a history of business expertise and knowledge matured outside forestry. Additional comments included:

- In-house expertise and good management competencies are essentials for successful businesses, in particular related to the absorption capacity of investments and accountability, but also with regard to silvicultural practice and managing social, environmental and governance issues and communication.

- Management competencies must support the development of business capabilities and not just for instance short term know-how on how to qualify for certification. Knowledge must be embedded within the organization and not be too dependent on individuals (which may leave the company and take all knowledge with them for instance).

- Forest certification helps to strengthen the reputation of the company by showing it has the management competencies required to manage a business sustainably, and not just in terms of forestry but also in terms of business administration and general management.

- Trust and reputation. In the forestry business – like any other -, trust and reputation are key assets on which it important to invest. Concrete ways to do that include certification (build reputation with markets) and develop good partnerships with local communities (build trust and reputation locally) and good relations with authorities.

- Knowledge of markets, how to access them, and negotiation skills were also mentioned as critical weaknesses of most small enterprises.

"For a small land-owner or community,
the hard work of 20 years [e.g., what it took to bring a teak plantation to maturity]
can go up in smoke in 5 minutes when you don't know the market
and/or are a poor negotiator."

Investor types and requirements

Understanding investor types and requirements – and the large diversity that exists!! - was identified as a key task for the forestry community. Participants recognized that there is a large gap to be bridged between members of the investment community and the forestry professions. Observations included:

- "The investor" as a concept doesn't exist; there are many different types of investors with differing objectives, priorities, preferences, and investment criteria. Consequently, finding the "right" types and mixes of investors is an essential step in the process of building a successful forestry business. In the search for the "right" investor, it is important to separate those that are open to work in frontier markets from those who do not.

- Similarly, "the forestry business" does not exist either; there is a large variety of forestry enterprises that operate in different types of forests and under different conditions with different objectives, priorities and preferences and management models, requiring different types and mixes of finance at different stages of their life. Given its characteristics and its "unknowness" in the status quo of the financing sector, the emerging forestry business initially may have to focus on kick-off investors (venture capital, charity, social and environmental non-profit foundations, or combinations thereof).

- Different phases in a forestry project need different types of funding. For example, funds from a NGO may be needed for developing management plans or certification, venture capital for hard infrastructure, PES for additional funding to improve protection of biodiversity during the project, etc.

- Investors on average are conservative and have a preference for particular countries and markets. If the business case is located in a new market, it is a bigger challenge to attract finance. Therefore, investors need to be identified that look further than the 'common countries' and common markets. Starting the search for an investor can therefore, start at the office of the Chamber of Commerce to discover which companies are operating in the country.

"Banks are not invaders, not innovators. We need to transform
forests into something they understand.

They don't know, and don't want to know, about FSC, forests, trees.
For the most part, they understand bonds and yields."

- For the above reasons, the role of credible intermediaries (whether they be investment advisors, NGOs, donors, or international organizations) is essential to provide the resources for the "soft investments" needed, to properly match investors and projects, and to provide both with a trusted interlocutor.

- Finance professionals in developing countries mentioned that it is relatively easy to locate financing for good projects up to about $1 M. Internationally, it is also relatively easy to locate financing for projects larger than $10 M. Projects within the range between $ 1M and $10 M are too big to be financed locally, and too small to be attractive to international investors. Yet, this is where most forestry projects fall, and which was identified as the "missing middle".

- Vertical chain companies, in particular those exporting timber could find support in timber importers to expand businesses in the country of timber origin.

- Rating restrictions are an important requirement that affect many investors. For example, some pensions funds cannot invest in non investment grade countries.

(National) Investment Fund Design and Financing

Given the current situation as to forest financing in many emerging/frontier countries, some of the participating countries considered the creation of (national) forest fund structures to be a practical solution, and felt optimistic that the resources could be found to finance it. A fund could have various functions:

- To act as a credible platform to connect the forest and financing sector,
- As an attractive vehicle to leverage investment from different sources (public and private, international and domestic) that is now untapped;
- To provide capital at sufficient scales and at competitive prices and as a business support vehicle that responds to the needs for developing specific forestry business categories.
- To enable sizable investment capital to be channeled to small and medium projects that, in isolation, are not sufficiently attractive because of scale issues.

Considerations mentioned regarding their design, development and financing:

- ***Fund governance and management:*** Who will manage it? If the parties involved have no credible track record, no investor will invest money. On the other hand, revealing anecdotal stories were shared regarding the rise and fall of forest funds in the Netherlands. Of the 47 funds that were created in the Netherlands over the past couple of decades, more than half went bankrupt. The prevailing reasons were financial mismanagement (excessive commissions charged on investors and overheads) by fund managers and intermediaries. However, the availability and use of proper forestry expertise was underlined as key to ensure the funds would be properly invested.

"A fund is just a box: it needs to be filled.
It is not true that 'creating a fund will be sufficient.'
A box alone without the proper governance or track record
will do nothing."

- ***Fund registration*** It will affect which investor it will attract. If registered in a developing country, it will take time for an European investor to check its legal status. A fund should be registered where it is easy for investors to check its legal status.

- ***Fund duration***: Discussions took place over the desirability of open-ended versus closed-ended funds for forestry. Investors at the moment tend to prefer closed-ended funds with duration of less than 10 years. While closed-ended funds can still be quite helpful for forestry, appetite for open-ended funds can be stimulated by providing alternative solutions to the needs for early exit and liquidity.

- ***Fund development.*** Once the fund is created, fund developers have about 6-12 months to fill the "box" with solid investment propositions. You have a maximum of 2 years time to find the money. If you do not fill the box in time you have to close it, the whole process starts again. Before you create a fund ("open the box"), you need to be already sure that solid investment propositions are available and that it will be filled (i.e., investors are interested in such propositions). It was also mentioned that a fund allows for public-private engagement and tapping from different sources which in itself improves the track record/credibility of the vehicle.

- Tax agreements and double tax agreements are important (related to registration). The fund may have to pay taxes in the country where it is registered. An European investor may also need to pay additional taxes in her country of residence. Tax treatments are a very important element in fund design.

- A question was raised on whether efforts should be directed toward designing a "replicable model" of a national fund, or toward a fund that would be appealing to international investors. Several participants considered engagement of a respected foreign partner in a national fund structure critical for its credibility and functioning in the case of their country. Participants concluded that in most countries forest fund development is in its infancy, that several models may work and that there is need to exchange emerging experiences (including from other sectors) and join efforts to bring some of these models further, particularly to identify the "key elements of the house" and develop guidance on that.

Participants also discussed that local pilots may be needed to build credibility and visibility for certain countries and activities.

Payments for Environmental Services (PES)

Attention was also paid to Payments for Environmental Services (PES), which seem an interesting opportunity to optimize and diversify additional revenue of environmental services by forests beyond wood on one hand and the returns on investments on the other hand. The most commonly recognized environmental service that can be monetized/marketed at this moment in time is climate change mitigation through the sale of carbon credits. Several challenges, however, have already emerged, including:

- The business case is experimental / in its infancy at this point in time;
- Selling carbon credits is currently complex, expensive and time-consuming and the platforms and rules/procedures for selling/trading are not well established yet;
- Uncertainty exists regarding carbon prices;
- There is a lack of collateral;
- Doubts remain about the applicability of the additionality principle (sometimes hard to demonstrate). Bundling environmental services may lead to double counting.
- Carbon services with additional social and ecological benefits (‘cuddle carbon’) are often more attractive than carbon “as a commodity”.

To mitigate in part these challenges a number of possible solutions were mentioned, including:

1. The creation of ‘tree planting certificates’ instead of carbon credits or stacking of environmental services
2. Add non-tree sources of income; e.g. intercropping (in the early years of a plantation);
3. Locate and engage the appropriate sources of finance;
4. Keep it simple!

Narrowing the gap: Additional considerations

A number of additional possible challenges or barriers to attract investments in forestry were mentioned, including:

1. The need for upfront finance to start up business initiatives versus long time horizons to achieve positive cash flow or break-even;
2. The call for sound forest management certification on one hand versus the associated costs and lack of short pay-back periods on the other hand (in particular the transition from not being certified to being certified is expensive – once certificates are in place the costs of keeping them in place are – on average – less);
3. A language barrier between the financial world on one side and the forestry professionals on the other side (need for a reference guide like: “forestry and financing for dummies”). Overcoming

this barrier also requires investments in capacity building, knowledge sharing events, and communication.

General considerations that seemed to be shared by to the entire group included the notion that:

- Before the gaps between forestry and finance can be bridged, they need to be described! These gaps include not only elements of the forestry business but also aspects such as biodiversity considerations, climate change mitigation, etc.
- The returns of forestry investments can be increased when ways are found to utilize wood residues ("they are residues, not waste") – the energy demand in the EU helps with generating an interest, but it is a commercial interest, not an interest in sound forest management, whilst the emerging markets want to create jobs etc, and don't want to be just the supplier of raw materials.
- There are institutional investors that can take an anchor position in forestry investments making capital available even if there are still substantial risks for institutional investors. The challenge is to find them and match them with the right business propositions.
- We need to concentrate on establishing the "missing middle": SME, also to alleviate poverty and empower people to fend for themselves, bearing in mind that sustainable development does not equal sustainable forest management.
- Natural Forest Management is critical and the recently emerged interest in REDD (Reducing Emissions from Deforestation and forest Degradation) may not create the most conducive environment for active management of natural forests. It was also noted that logging, even in certified forests, can result in damaged and reduced ecological system functioning. As a result, setting aside untouched forest areas should be part of a strategy to achieve sustainable forest management.

"We have developed the "Sicirec Formula",
through which parts of the original ecosystems are left untouched,
exploiting only (the greater) part of the area, preferably FSC-wise.
Only in that way we can hope to maintain rather complete ecosystems.
We know of no other way."

- The lack of trust between parties is often getting in the way of creating a conducive investment environment.
- This is but the beginning of the learning journey.

Recommendations for follow up

A number of recommendations were made and discussed by the participants, including to:

1. Further elaborate the key design features of a forest investment fund to stimulate private investment in forestry. A possible activity could be the joint preparation of a working paper

based on the preliminary work done in Paraguay and Indonesia and on other existing (and successful) forest funds (and similar experiences in other sectors).

2. In bridging the gap between opportunities and finance the role of intermediaries is critical. They can assist in properly matching investors and projects, act as "business incubators" to build management capacity, provide the resources for the "soft investments" in institutions that are often needed, and provide both parties with a trusted interlocutor. It was recommended to explore ways to better understand and guide intermediaries (investment advisors, NGOs, donor agencies, international organizations) that are working to link forestry opportunities with investment capital. Concrete next steps include the preparation of an "inventory" of organizations that perform these roles, the search of intermediaries to invite at future meetings, and the provision of feedback to the "Investment Support Guide" currently being developed as part of the Investing in Locally Controlled Forestry (ILCF) Initiative of the Growing Forest Partnership (GFP).

3. Further consider the development of standards (or minimum requirements), benchmarking, etc., to help enterprises assess their own "investment readiness" and the risk profile of their business propositions. Further consider partnerships with "business incubators" such as FAST International (ForeFinance is currently developing a credit risk assessment method), BID Network, and TreeAid to assist in the coaching and capacity building for the development of sustainable/bankable business cases.

4. Follow up on the request by the Dutch finance community to better understand the forestry business by organizing a field trip in the Netherlands.

5. Follow up with the possibility to support a National Forest Finance Strategy in Indonesia.

6. Follow up on country activities in Uganda, Peru, El Salvador, Paraguay and Guatemala through the national facilitators.

7. Consider a follow up meeting in the next 9-12 months in Switzerland or Germany, where the development and implementation of selected topics could be advanced. Consider participating in the conference on "Investments in Sustainable Forestry in Emerging Markets: Bridging the gap between investors and projects." Conference is co-organized by FORM International.

8. The meeting was also an opportunity to gather video interviews and we will work on producing a short video in the next couple of weeks. We also tested live web-streaming of the event. The test was successful and opens the possibility for sharing more broadly what is exchanged in this type of meetings. Consider using live web-streaming of events to make possible virtual attendance to participants that cannot physically attend.

The meeting also provided the opportunity to follow up on country activities (Guatemala, Paraguay, Peru, El Salvador, Uganda, Bolivia), explore new possibilities for partnerships (e.g., a forest finance fair in Peru with FAST International and the Amazon Alternative), discuss the status of a study on institutional investors (f.i. pension funds and insurance companies) and forestry, and possible activities on forest finance in Asia. Finally, it provided an opportunity for forest finance experts to exchange experiences and lessons with their counterparts in other countries and for networking.

FAO, the NFP Facility, Tropenbos International and the other partners are in the process of preparing a plan for follow up actions.