

ISSUE NO. 54, DECEMBER 2012



Good Business: Making Private Investments Work for Tropical Forests

EUROPEAN TROPICAL FOREST RESEARCH NETWORK



1.2 Responsible investment in emerging timberland markets

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Introduction

A rising global demand for wood products — along with environmental and social pressures to conserve natural ecosystems — suggests that timber will increasingly come from managed plantation forests. Natural forests are complex to manage, have relatively low timber productivity over the long term, and, if managed sustainably, must carry the cost of conserving ecosystem services.

The only viable alternative, in order to meet the projected global demand for timber, is to shift the forest product industry from being based on extensive, low-productivity harvesting of natural forests to intensive, high-productivity plantations or semi-natural forests, which produce more timber on a much smaller land area. Independent third-party certification of sustainable forest management and supply chain traceability can support the management and mitigation of environmental and social impacts.

New Forests¹ believes that the expansion of forest plantation area will take place mostly in tropical regions or the Southern Hemisphere, where growth rates are faster than in the traditional temperate and boreal forest regions of North America and Europe. This process is already underway; in recent years plantation area has expanded in Latin America, Asia and Africa, as well as Australia and New Zealand, which supply timber to East Asia. As a result, institutional investors who want to buy in to the timberland asset class will have to consider investing in timberland in emerging markets.

For those investors who consider environmental, social and governance (ESG) risks as integral to investment strategies, portfolio construction and asset management, sustainable timberland investment in emerging markets can be very attractive. Such investments can meet investors' financial objectives in an environment of rising climate change risk



SUSTAINABLE TIMBERLAND INVESTMENTS IN EMERGING MARKETS ARE RESILIENT TO CLIMATE CHANGE RISKS AND CAN DELIVER TANGIBLE POSITIVE SOCIAL AND ENVIRONMENTAL IMPACTS.

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and can contribute to an industry-wide transition to a more sustainable future. This in turn can generate tangible positive environmental and social impacts.

Investors will therefore need to understand both the risks and opportunities involved in investing in emerging timberland markets. This article helps investors understand what those risks and opportunities are and how they can be measured, priced and managed.

Managing investment risks in emerging timberland markets

Investment risks in mature timberland markets such as North America are generally well understood by institutional investors. These risks generally relate to timber markets and pricing, production, regulation and liquidity. Investment in emerging timberland markets is relatively new, however, and involves country and currency risks as well as ESG risks. Chief among these additional ESG risks are climate and biodiversity risk, land tenure risk and operating risk. Each risk requires context-specific management strategies that will be unfamiliar to investors in more mature timberland investment markets.

Climate and biodiversity risk

The degradation of tropical and subtropical natural forests through unsustainable logging or conversion to agricultural land — with its associated carbon emissions and loss of ecosystem services — is a key risk across the forestry asset class in emerging markets. Regulatory sanctions on unsustainably sourced wood products, along with shifting market preferences for sustainably sourced products are just two ways in which these risks can affect revenue from forestry assets. Other risks include supply disruption or insecurity as raw material sources are depleted and increased costs of capital and reduced asset liquidity as lenders, investors, and buyers reduce their exposure to the affected assets.

Commercial and regulatory pressures to increase the supply of forest products that have been certified by an independent third party as sustainably managed have grown over the past decade. This is largely a response to the risks associated with investments in natural forest operations or in plantations developed on land cleared of natural forest.

The Forest Stewardship Council (FSC)² has the most widely accepted forest certification scheme. Its rigorous standards require demonstration of sustained yield of timber over the long term and preclude the certification of plantations established on previously forested land after November 1994 unless there has been a change of ownership. The sale of FSC-certified tropical hardwoods can attract significant price premiums that more than compensate for the costs of certification.

However, using FSC as the benchmark for an investment can also limit the pool of investable assets in some emerging market countries where forest conversion has recently taken place and the existing owners want to retain an ownership stake in the company. In such situations it may be necessary to seek certification through alternative schemes, such as the FSC's Controlled Wood Standard for forestry operations. FSC-certified Controlled Wood can be combined with fully FSC-certified timber or fibre into FSC mixed products bearing the FSC label, although it is unlikely to attract the same price premium as fully FSC-certified material.

In some cases, even where the existing owners are willing to sell their full share, FSC certification can restrict the number of transactions that an investor can make. For example, where natural forest conversion is legally sanctioned and there are areas of natural forest within the licence area that remain unconverted, the existing owners may place a commercial value on that forest. An incoming investor intending to get the asset FSC-certified is going to have to set aside the forest for conservation. This makes agreement on price much more difficult.

In such situations it may be necessary to monetize the natural forest's carbon and ecosystem services (e.g., through the production of voluntary market carbon credits) and pay the existing owner something for this. For example, New Forests has identified a plantation and natural forest asset in Malaysia that is approximately 55% established timber plantation and 45% natural forest, with rights to harvest and undertake land clearance in order to expand the planted area. Because of investment restrictions, the natural forest cannot be harvested and converted to plantation. In developing an investment model for the asset, the bid price is likely to differ significantly from that of a buyer without such environmental sustainability restrictions, as such buyers would place higher value on the natural forest land. Instead, New Forests has considered the commercial value possible through forest carbon and biodiversity projects, which would preserve the natural forest and its ecosystem services.

Another alternative is to develop greenfield³ sites on land that ceased to be forest several decades ago, such as abandoned former agricultural land. In many forest-rich emerging-market countries where there is a history of slash and burn agriculture, such areas can be quite extensive. According to the IFC, for example, there are 96 million hectares (ha) of degraded land in Indonesia, at least 8 million ha of which is abandoned agricultural land that is now covered with coarse *Imperata cylindrica* grassland (IFC 2010).

The IFC's Performance Standards⁴ are another set of environmental and social criteria that can be applied to timberland investments in emerging market countries. The IFC recently adopted a more flexible solution to managing deforestation risk. Applying this framework, a plantation company could convert areas of natural forest so long as it was able to demonstrate no net loss or a net gain of biodiversity through the use of approved mitigation measures.

There are, however, several challenges to this approach. Its methods and approaches require expert input and can be time consuming. In addition, the IFC's Performance Standards are not a recognized timber market standard and do not support any form of product label. Potential price premiums, such as those possible for FSC-certified timber, are therefore not an incentive. Further, there is a lack of understanding and acceptance of biodiversity offsets among environmental NGOs active in the forest sector, which generates potential reputational risk.

Land tenure and licensing risk

One of the most challenging aspects of investing in forestry, particularly in emerging markets, is understanding the context of land tenure, licensing and forestry rights. This understanding is essential for investors to navigate the regulatory and institutional framework that provides investment security. Land tenure and licensing require careful attention when investing in land or natural resources in any market. In Southeast Asia, the institutions supporting the forest industry vary from country to country, and in some cases regulatory frameworks vary within each country. Investing in a country will require familiarity with key issues:

- relevant land and forestry regulations that affect forestry investment, including foreign investment rules;
- customary use regulations and/or how forestry regulations incorporate customary use;
- incentives and structures for encouraging forestry investment; and
- licence provisions.

Unclear land tenure, overlapping rights and the possibility of contested or revoked licences are risks that could jeopardize the stability of investments in forestry plantations. Clarity of land tenure should be addressed as part of any due diligence process.

New Forests' analysis of such incidents in Southeast Asia indicates that licences are revoked only in cases where the licensee has materially failed to undertake agreed activities. For example, if a licence is issued for plantation establishment and minimal or no planting occurs, the issuing authority may revoke the licence for failure to comply. Across the region governments are keen to expand the area of forest plantations to supply their domestic wood-based industries. They recognize that foreign institutional investment will be a key part of this.

In some cases a further risk can arise: it may be possible to secure controlling rights to the tree crop but not the underlying land. This can be resolved through an appropriate investment structure, the selection of reliable parties and the use of political risk insurance, such as that provided by the Overseas Private Investment Corporation in the United States. Funds that include development finance institutions or state-linked sovereign wealth funds as limited partners, particularly with access to high levels within government, can provide additional investment security. As a protection in the event of legal action, independent arbitration clauses that specify more established jurisdictions as the seat for any arbitration process can also help to keep parties honest, and to resolve disputes if they arise.

Land tenure also involves important social and ethical aspects of forestry investment; many tropical timber plantations have indigenous or local communities living in or near them. Investment due diligence should include detailed legal review and stakeholder consultation with all relevant indigenous peoples groups and NGOs. This is in line with activities required for FSC certification and IFC Performance Standards.

Best practice includes the process of obtaining free, prior and informed consent (FPIC) from affected communities. Indigenous peoples' right to FPIC is recognized by a number of intergovernmental organizations, international bodies, conventions and international human rights laws and a number of FSC-certified forestry operations in emerging markets have obtained community consent. IFC Performance Standards also provide guidance on community resettlement and appropriate compensation mechanisms.

Some successful examples of land tenure arrangements use a combination of measures:

- set-aside sites of special community significance;
- compensation arrangements for use of land; and
- assistance in mapping and formalizing customary land rights through local government decree and forest delineation.

In several cases, New Forests' due diligence has identified discrepancies between vendor statements regarding resettlement or occupancy of licensed areas and the actual status of local communities across assets. In some instances, communities may be largely comprised of recent economic migrants, and local government may have plans to resettle



communities or excise occupied land from the land available for plantation management. Undertaking a community resettlement programme — with indirect control over how the process is conducted — is likely to be tortuous and high risk. Wherever possible, it is advisable to agree on and formalize existing settlement boundaries and/or negotiate compensation or outgrower schemes that can help to stabilize the forest frontier, align interests and provide clarity on future arrangements. It is critical that such issues be identified early on through the use of experts in stakeholder engagement. Community engagement should also be

integral to ongoing forest operations. Active engagement and the use of transparent and clear mechanisms to resolve grievances can promote healthy relationships between plantation companies and local communities.

Operating risk

Operating risks — particularly forestry, biophysical and technical risks — are well known in established markets. Where there is a long history of plantation management, factors such as species choice, silviculture and presence of experienced professional managers encourage forestry investment.

In emerging markets, this knowledge base is generally not as well established. An exception to this is the agricultural sector, such as oil palm and rubber in Malaysia and Indonesia. Rubber cultivation in Southeast Asia began over a century ago and there is significant body of local expertise and managerial capacity in establishing and operating forest plantations.

New Forests seeks to combine this local operational expertise with specific international forest plantation experience in the management of its rubberwood plantation assets. Such situations require managers to have sufficient in-house technical expertise to build operating teams for assets and ensure adequate levels of supervision and support. FSC certification and independent verification of compliance with IFC Performance Standards, combined with regular management audits, can also help provide the framework for a high quality of management.

This type of holistic sustainability approach incorporates ESG management and allows for third-party verification, providing investors with additional assurance that their assets are being managed responsibly. By using an appropriate combination of certification, investments can demonstrate that high standards for operating practices are being met for forestry and technical areas and for matters relating to business and employment practices.

Measuring risk

The measurement of risk is an important component of any timberland investment. Although investors have a number of tools to help manage financial risk, emerging markets typically have fewer mature forestry investments, making it more difficult for investors to ensure they are estimating risk accurately. Country and sovereign risk primarily relate to business culture, legal system effectiveness, government policy environment and regulatory stability. Considering these factors is important for any investment in emerging markets. A growing body of investment tools is available to asset owners and managers to improve their management of country risk, including qualitative and quantitative methods.

Qualitative analysis relies on subjective analysis of risk factors and investment climate, such as significant political events or market information. Forestry investment in emerging markets requires keen consideration of these risks, particularly since corruption and the ability to protect property rights may affect an investment's performance. Sophisticated investment will require the use of good judgment to evaluate country risk for the forestry sector, land and natural resources rights, and foreign investment.

From a quantitative perspective, country risk can be incorporated into the investment process by including a country risk premium on expected returns and in discount rates used in asset valuations. Country risk may be estimated in a number of ways; some service providers now provide country risk indexes and other tools. One approach is to look at yields on the country's sovereign bonds compared to the rate on "risk-free" government bonds such as U.S. treasuries (Damodaran 2012). This needs to be combined with an estimated risk premium for timberland investment in the selected country.

Another approach is to compare implied discount rates used in purchases of timberland assets in the country with the U.S. market, which is the most mature timberland investment market. The premium derived in this way will include sector-specific and operating risks associated with timberland assets. In Southeast Asia, for example, unlike in the U.S.,

forestry land is leased to private companies and cannot be freeheld by an investment fund or trust. This generates a private equity element to timberland investments in the region that presents its own risk premium.

The equation to calculate discount rates for potential assets becomes (in real terms):
 Asset-specific discount rate = U.S. timberland discount rate + country risk premium + sector/operating risk premium.

There is also likely to be an additional currency risk premium. Even while new approaches allow an increasing number of risk factors to be measured, a combination of qualitative and quantitative risk assessment is required; this will make pricing of risk more accurate. Active risk mitigation during acquisition and asset management processes is also important. For example, establishing partnerships with international agencies and groups operating within an area can enhance an investor's ability to conduct business effectively in emerging markets.

Environment and social opportunities

By investing in plantations in emerging markets, investors can help drive the transition of the industry away from extensive and destructive management of natural forests



— with its associated carbon emissions and other social and environmental costs — and towards a more intensive, sustainably-managed plantation resource base. In the process, investors can benefit from appropriately risk-adjusted returns with low volatility and a strong inflation link that at the same time deliver highly beneficial sustainable development outcomes.

Sustainable forest management practices and the use of environmentally sensitive forestry practices will produce direct local benefits, such as maintenance or enhancement of high conservation values and biodiversity. On a larger scale, well-managed plantations can reduce net greenhouse gas emissions and relieve pressure on native forests, particularly where combined with monetization of the carbon and other ecosystem services that natural forests provide.

The social benefits of sustainably managed plantations and responsible investment include improvements in local livelihoods and safe and healthy working conditions for people living and working in plantations. There may also be scope to support the improved recognition of customary land rights.

Responsible investment will also drive improvements in governance. Private-sector development is a key goal for many emerging economies. By bringing foreign capital to support business development, there are direct economic benefits. Institutional investors are also likely to require corporate governance measures that demand a high standard of accountability and ethics in business practices. At the same time, there is further incentive for the government to maintain stable institutions and economic conditions

that support investment in local industry. These factors combine to provide momentum for ongoing improvements in business culture and economic development based on a local renewable industry.

New Forests believes a responsible investment approach to tropical timber plantations will have multiple commercial and ESG benefits. Traditional risk management in forestry focuses on the areas of biophysical, regulatory, financial and operating risks. As investment capital moves into less mature forestry investment regions, such as Southeast Asia, Africa and Latin America, investors will encounter a growing number of ESG risks. If these risks are effectively managed, however, investment objectives can be met and substantial and long-term sustainable development outcomes can be delivered. This includes the successful transition of the forest industry as a whole to a more sustainable model.

Endnotes

1. New Forests manages investments in sustainable forestry and associated environmental markets, such as carbon, biodiversity and water, for institutional and other qualified wholesale investors. The company is based in Sydney, Australia.
2. See <http://fsc.org>.
3. Greenfield land is undeveloped land in a city or rural area used for agriculture, landscape design, or left to naturally evolve. These areas are often agricultural properties being considered for urban development.
4. See www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/Sustainability+Framework+++2012/Performance+Standards+and+Guidance+Notes+2012.

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