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briefing

Quality investment

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Ringing the changes with a new approach to forest investment

Policy pointers

- **'Quality' forestry** investments must balance financial returns (for asset investors) with social justice (for local forest people) and environmental sustainability (for us all).
- **Such quality investment** often needs a mix of 'enabling' investments that build investible businesses controlled by local people, and 'asset' investments that unlock those businesses' potential for financial, social and environmental returns.
- **The Investing in Locally** Controlled Forestry (ILCF) framework encourages wise 'enabling investments' from development donors that ultimately attract larger capital from commercially minded 'asset' investors.
- **ILCF requires innovative** partnerships between government decision makers, development donors, NGO intermediaries, asset investors and local rights holders that jointly recognise the crucial role astute enabling investments play in unlocking the potential of asset investment in forestry.

Three trends lie behind renewed investor interest in forestry: tightening supply, increasing demand, and its role as a hedge against financial uncertainty. But people with local rights invariably live in forests, however sparsely, and forests are crucial ecosystems for everyone. So quality investments must balance acceptable returns, social justice and environmental sustainability. Investing in Locally Controlled Forestry (ILCF) is a negotiated framework for striking this balance. It promotes innovative partnerships to mix enabling investments (that put in capital to build sustainable and investable businesses) with asset investments (that expect a return on capital). In other words, quality investment in forestry comes when development donors offer targeted enabling investments that can in turn attract the right sort of asset investments. Case studies from Asia, Africa and Latin America illustrate how this balance can be achieved.

Why forestry is investable

Forestry is back on the investor map. Tightening supply (through deforestation) and rising demand (for conventional products, emerging ones like biomass fuels, and environmental services such as carbon storage) are boosting financial returns. Forestry's strong physical asset base (in land, timber and processing capacity) also make it attractive in times of financial uncertainty, with trees' physical growth adding value that is broadly aligned with pension fund liabilities. Economic logic lies behind rapid afforestation in China, Europe, the USA, India and parts of South East Asia.

Over the past 20 years, forestland has outperformed the broader equity markets (for example, annual returns from US Timberland Investments have averaged 14.9 per cent) and also enjoys better risk-adjusted returns because of its relatively low volatility.[1] Forestry's significant advantage is that investment returns are uncorrelated with those of other asset classes (whether they are from locally controlled woodlots, natural forests or large industrial plantations). And that holds true across the multiple commercial sub-sectors based on trees (for example, food crops, energy crops, fibre crops and bundles of ecosystem services).

With largely saturated Northern investment opportunities, and considerably faster growth in the tropics, investors are turning to the South, despite traditional risk-related aversions.

Why forestry needs 'quality' investment

What complicates forestry investment, particularly in the South, and is considered either a threat or opportunity depending on viewpoint, is people. Globally, forests support 0.5 billion indigenous people and 1.3 billion other forest people who live in, depend on, and have traditional knowledge attuned to forests. They invariably have customary or formalised land rights (we will refer to them as local forest rights holders here) and non-negotiable basic needs for food, fuel and fibre.

And indirectly all of us ultimately depend on forests — to store carbon, maintain water supplies and soils, and to preserve the biodiversity that lets our environments adapt to change. So 'quality' forestry investments are needed that make an acceptable return without marginalising local forest rights holders or degrading locally and globally significant ecosystems.

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‘Quality investment’ in forestry must go beyond simple economic return

Recent assessments of investment in industrial forestry show little impact on poverty reduction among local forest rights holders. These people are often marginalised in industrial plantation developments or large natural forest concession logging operations.[2] Nor has the expansion in industrial forestry stemmed the loss of biodiverse natural forests. Economic gain does not intrinsically respect social justice or environmental sustainability.

‘Quality’ investment in forestry must go beyond simple economic return. It must recognise that forest landscapes are inhabited (however sparsely) by peoples who have rights over forest resources. The old model of capital seeking forest resources and requiring cheap local labour must be replaced by one of local rights holders managing forest resources and seeking capital — the start-point for locally controlled forestry.[3] Not only does locally controlled forestry address issues of social justice, it has also been shown to enhance environmental management.[4] Investing in Locally Controlled Forestry (ILCF) is a whole new approach to quality investment in forestry.

Unpacking the term ‘investment’

Investment means different things to different people. Nine international dialogues on ILCF[5] clarified the links between two distinct types of investment:

- **Asset investment.** Conventional profit or product oriented investment that expects the nominal value of underlying capital to increase, or at least not fall.
- **Enabling investment**. In which capital is put in, and sometimes written off, to build the self-sufficiency and attractiveness of the business in question. Ultimately, this creates the conditions for asset investment.

In many forestry situations — especially local businesses in underdeveloped regions — asset investment is rarely possible unless preceded by enabling investment. For example, an asset investor wants to know that a business is registered, has secure commercial forest use rights (with some liquidity and access to collateral should the business fail), adequate management and leadership, and that the operation will have sufficient scale and cash flow to cover the costs of setting up the investment (for example, due diligence investigations). Many local forest enterprises simply do not have these essential foundations.

But government authorities, donors and intermediary NGOs can help build these foundations, gearing support to building investment preparedness against rigorous (and ultimately financially sustainable) private sector criteria, without compromising a tough stance on exploitative deals. This ‘enabling’ investment might take the form of advocacy, formal registration of rights and collateral, capacity development (through business training or mentoring), or help building an association big enough to attract investment. It is a very different approach to the too-common problem of NGOs propping up sub-standard businesses for social or environmental ends.

ILCF delivers quality, but takes partnership

Ensuring quality investment in forestry usually requires a mix of enabling and asset investments. Often that is through an innovative partnership involving government decision makers, development donors, NGO intermediaries, asset investors and local forest rights holders. The concept of ILCF can build these partnerships. Local control means local rights holders are in the ‘driving seat’ for the relationships that deliver both types of investments, and also take on the responsibilities that go with commercial development of their rights — such as sustainable management of the forest.

It is a self-reinforcing process (see Figure 1) in which enabling investments (big arrows in Figure 1) lead to secure commercial forest rights and capable and organised businesses under rights holders’ control. These can attract fair and balanced asset deals — which deliver acceptable returns while further strengthening resource right claims, local capacity and strong local profit-related incentives to restore or maintain forest cover.

Quality investment in practice

ILCF can already be found across a wide range of product and business types. Here, we give three examples from different contexts and continents, illustrating how enabling investments have paved the way to asset investments — be they loans or equity. Here, we give three examples from different contexts and continents to illustrate how enabling investments have begun to pave the way towards investable businesses. Each example has managed to attract asset investment — be it in the forms of loans or equity.

Mahogany and Xate from Guatemala. In 1995, community leaders established the Association of Forest Communities of Petén, Guatemala (ACOFOP). ACOFOP formed to represent 22 organisations from 30 communities defending their rights to benefit from new community concession legislation within the Maya Biosphere reserve.

ACOFOP worked hard to secure commercial resource rights (first circle in Figure 1) and ensure that its constituent member organisations were able to access community forest concessions. They fought for a new regulation: policies on granting concessions for the use and management of renewable natural resources in the multiple use zone of the Maya Biosphere reserve. Enabling investment in this advocacy role came from the Ford Foundation, the Dutch Interchurch Organization for

Development (ICCO), the German Development Service (DED) and the Swiss Cooperation Agency (Helvetas).

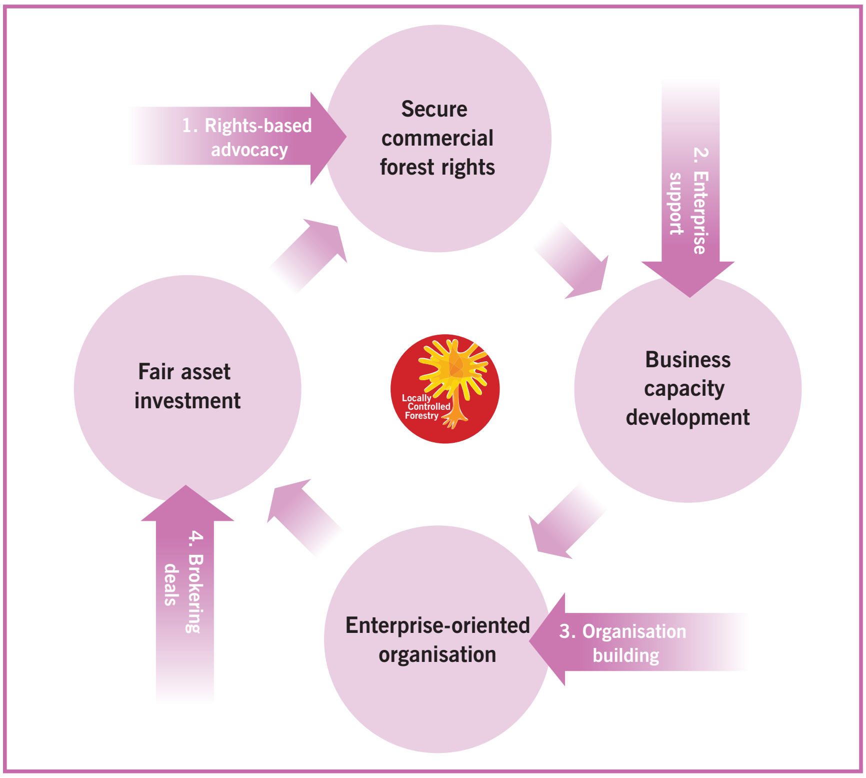
When it came to business capacity development (second circle in Figure 1), USAID joined the donors above and helped set up the Community Forest Concessions Organisation (FORESCOM). FORESCOM focused on sustainable timber extraction and processing through a community funded sawmill — with certification by the FSC. More recently, support has come from the Rainforest Alliance, with small additional funding from the FAO (through the Forest Connect alliance). They have helped develop timber, but also non-timber forest products such as leaves from the native Xate palm, used in flower arrangements. Business capacity development has included training funded by AGEXPORT DANIDA to: re-establish Xate palms in degraded forest; improve quality control; produce and institutionalise management plans; and improve marketing through better packaging and transport.

Ten well-developed organisations within ACOFOP now work through FORESCOM to sell a range of timber products (enterprise-oriented organisation — third circle in Figure 1). The most important product is Mahogany (Swietenia macrophylla) exports worth approximately US$6 million. A further five community organisations within ACOFOP work together on non-timber products, planting more than 5 million trees, harvesting, processing, packing and exporting Xate leaves. Annual exports are now worth approximately US$300,000 per year, mainly to the USA. At the national level, 11 umbrella associations combining 300 communities and 63 constituent community enterprises have federated Guatemala's National Alliance of Community Forest Organizations (the 'Alianza') — with enabling investment from the Growing Forest Partnerships initiative.

And the enabling investments have brokered fair asset investment deals (fourth circle in Figure 1). The concessions ACOFOP oversees are profitable and secure, letting concessionaires borrow from mainstream banks such as the national BANCAFE and BANRURAL or the regional Central American Bank for Economic Integration. And FORESCOM timber businesses have attracted asset investment. For example, a loan from OKIOCREDIT has bought three drying kilns, a fork lift truck, and has built a warehouse. In addition Xate producers have benefited from Inter-American Foundation investment to purchase and maintain vehicles, and to build and furnish warehouses.

Teak from Indonesia. Dipantara, established in 2006, built its business based on sustainable teak growers groups in Gunung Kidul, Yogjakarta, Java. The company could be set up because local teak grower groups have secure commercial rights to grow and sell timber. Each group organises its own members, develops its own management plan and is free to partner Dipantara or sell to competitors. The tenure situation is unusual in

Figure 1. Quality investment in forestry. Enabling investment (arrows) puts in place the self-reinforcing ingredients for locally controlled forestry (circles), which often include fair asset investment.



Indonesia where most forest land is governed by a range of policies for customary (adat) and formal community use — requiring a range of permits and licences that can be difficult to obtain.

Dipantara benefited from enabling 'business capacity' investments from The Forest Trust and ICCO. They helped farmer groups and Dipantara staff pursue Forest Stewardship Council certification. Frontier, an organisation based in Yogyakarta, provided business training. The partnership with The Forest Trust and ICCO helped Dipantara develop a three-year business plan for 2010–12. Dipantara grows and provides free seedlings to growers groups and runs technical training courses that help farmers manage their plantations sustainably. Dipantara also helps communities establish management units and develop forest management plans that define the annual allowable cut, maintain tree inventories, develop mapping capacity and promote sustainable harvesting and agroforestry.

Dipantara developed itself as an enterprise-oriented organisation with enabling investment from Perhutani (the government forest service). Dipantara had 10 farmer groups in 2008, but had 96 farmers groups by late 2011 and hoped to attract 30 more in 2012. That would take individual membership far above 3,000. Members are attracted primarily by higher than market prices for teak. Yet internal efficiencies mean Dipantara can price products competitively — at 15 per cent lower than the State forest service Perhutani.

Dipantara is now well established, with investment in the form of conventional bank loans for example to develop harvesting, transport and log-yard facilities. But rather than seek major equity investment in processing capacity the company has currently opted for a business partnership arrangement. It works with well-established, high-quality sawmill and furniture producers, such as PT. Java Furni Lestari, that use community-sourced timber and sell furniture to a range of national and international markets.

Shea butter from Burkina Faso. In 2001, the women of Sissili and Ziro provinces in Burkina Faso set up a Women's Union for producers of shea products. Initially known as UGPPK, the Union became the NUNUNA Federation in 2011. It aims to reduce poverty and improve the status of women involved in shea butter production, most of whom are illiterate.

Shea butter production is based on customary patterns of resource use, in which women's groups harvest shea nuts on public land on the basis of customary rights. Enabling investment by the NGO TreeAid has led to ongoing discussions with government over how to establish more secure commercial rights and so create a stronger incentive to enrich or restore forest areas with desirable trees like shea. So far, NUNUNA members have themselves introduced informal measures to protect and conserve 3,345 hectares of shea-tree areas.

Business capacity development began in 2003, when the original Union benefited from a commercial deal with the cosmetics company L'Occitane, which agreed to buy shea from 600 women to certain specifications. This deal catalysed the Union's commercial development, with support from technical partners for development such as the Centre for International Studies and Cooperation, ICCO and the international NGO SNV.

NUNUNA has rapidly developed enterprise-oriented organisation. NUNUNA started as a union among 18 groups district-wide, but now comprises 4,596 members, a growth of 156 per cent over the 2,985 members of 2009.

In order to atract fair and balanced asset investment deals, NUNUNA worked together with SNV to develop a new business model which included an investment proposal for constructing a small shea butter processing factory. The Argidius Foundation stepped in with an asset investment to construct a fully mechanised and efficient production facility. NUNUNA's production capacities rose from 300 mt to 600 mt a year and the production costs per kilo of butter fell 95 per cent (from 1.68 €/kg to 0.86 €/kg). In 2006, 32 groups gained fairtrade certification, and the whole federation gained organic certification in 2007. These technological improvements and certifications have helped the 4,000 members achieve a 95 per cent increase in income from shea production, while the position and workload of women shea nut collectors has also improved.

Each of the three cases show how innovative partnerships built investible businesses through enabling investments that ultimately led to fair and balanced asset investment — either through loans or equity.

In summary, quality forest investments need different actors to change their approaches. Governments need to wise up and grant local people the secure commercial rights needed for all (or any) investments. Development donors and asset investors should look to form innovative partnerships with local rights holders. These can let donors bear some of the 'enabling' costs so that the core business achieves acceptable returns alongside social and environmental co-benefits. And local rights-holder groups, who often look to others to make progress, need to invest in their own business capacity, strength of organisation and ability to strike deals that strengthen local control. In this way, Investing in Locally Controlled Forestry can deliver 'quality' forestry investments that bring financial returns, social justice and environmental sustainability.

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This briefing draws on two strands of his work: (i) reviewing the Investing in Locally Controlled Forestry dialogue series coordinated by The Forest Dialogue and funded by the Swedish International Development Cooperation Agency and the World Bank's Growing Forest Partnerships Initiative; and (ii) co-managing with the United Nations Food and Agriculture Organisation the Forest Connect alliance that supports small forest enterprises, funded by the World Bank Programme on Forests (PROFOR), and UK aid from the UK Government.

About the series

A commercial investment's 'quality' determines whether it promotes or undermines inclusive sustainable development in low-income countries. This briefing is part of an IIED series that investigates the notion of quality investment across different sectors and themes. Individual briefings do not start from a specific definition of quality investment. Rather, a final briefing will review the series and discuss implications for such a definition.

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