

Policy pointers

Public sector funding of forest-linked small and medium enterprises can overcome barriers to investment and enable the development of viable, sustainable and inclusive businesses, attracting private funding.

Funding and support should include comprehensive capacity development by qualified and credible service providers, covering all areas of business planning, management and monitoring, to reduce actual and perceived risk and ensure that small and medium enterprises are ready to engage with credit institutions.

Whilst the cost of 'enabling funding' for small and medium enterprises is important, supporting enterprises to reach scale brings significant economic and environmental benefits, and will repay investment.

Public and private sector financing must promote the contribution of forest-linked small and medium enterprises to achieving the Sustainable Development Goals through climate mitigation and adaptation and social inclusion measures.

Unlocking barriers to financing sustainable SMEs: uphill struggle or attainable ambition?

Formal and informal small and medium enterprises (SMEs) are key players in forest-linked value chains, creating jobs, generating tax revenue, and meeting domestic and international demand for forest products and services. Appropriate investment, capacity building and management could have a multiplier effect on the sector, significantly increasing its outputs and benefits. SME development does not seem to be hampered by lack of potential investment funding, but rather by barriers such as 'fear of risk' by both financing institutions and SMEs, and SMEs' 'poor business capacity'. Innovative public finance mechanisms and public-private funding partnerships are needed to build business capacity of SMEs and attract private funding. Both public and private finance should include appropriate environmental and social criteria.

This briefing examines the challenges and opportunities of securing finance for forest-linked small and medium enterprises (SMEs), and offers policy pointers towards sustainable financing of the sector.

The briefing is based on two case studies, which explore the barriers and opportunities to sustainable funding of forest-linked SMEs in Guatemala and Mozambique. The case studies are based on ongoing desk research; semi-structured interviews with key actors, including representatives from government, finance and SMEs; and discussions in a number of high-profile forums. The study was informed by initial analysis identifying six key factors affecting the willingness of funders to offer finance to SMEs, and SMEs to accept such funding (see Figure 1), and draws on the sources listed.¹⁻⁴

The study examined two types of enterprises: forest-linked enterprises (including natural forest management for timber and non-timber forest products, protection of natural forests and development of plantations); and commercial agriculture, which often involves significant deforestation.

The global agenda

The Paris Agreement and the UN Sustainable Development Goals (SDGs) set climate change and development agendas that will require transformative changes in land-use practices associated with forest-linked value chains. Both large corporations and SMEs need to reduce their climate-related impacts, for instance through reduction of emissions from deforestation and the supply chain, and adaptation to climate change, in order to ensure these goals are reached.

Moreover, although the forest-linked SME sector is often informal, dispersed and volatile, its potential to create jobs, generate tax revenue and meet demand for sustainably produced products and services means it *could* make a significant contribution to meeting the UN's ambitious SDGs — particularly SDG 13 on climate action, SDG15 on sustainably managing forests, SDG 8 on inclusive and sustainable economic growth, full and productive employment and decent work for all, SDG5 on gender equality, and SDG 17 on means of implementation.

An estimated US\$70–160 billion funding per year is needed to allow for the sustainable management of global forests — and the good news is that there *are* funds available, some of which could be used for SMEs. Funding sources range from international funds that support the UN's REDD+ Programme, the Forest Carbon Partnership Fund, the Forest investment Fund and the Climate Investment Fund, to bilateral government development assistance and private sector funders.

Financing mechanisms and opportunities for SMEs

Both Guatemala and Mozambique register increasing public investment to support SMEs,

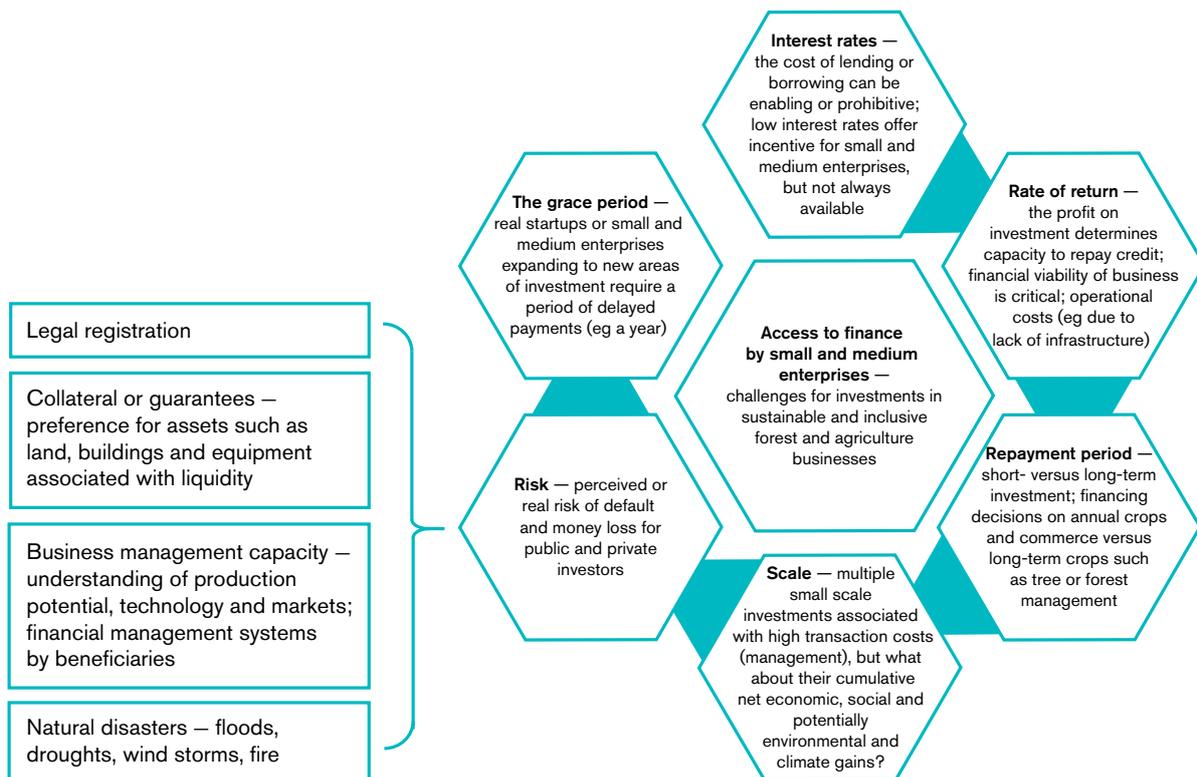
including in building their business and management capacity. This helps to offset initial risk and establish viable enterprises able to unlock private and international finance. Early financial viability is critical to reassure investors, and the businesses themselves, that they will achieve the returns required for growth and consolidation, and vital to creating business-readiness to embark on long-term development of sustainable enterprises.

Guatemala. The Guatemalan government has made an innovative commitment to invest one per cent of its budget in financing sustainable land-use — a bold move that could be an example to other countries. Funds are dispersed through programmes such as PINFOR (1996–2016) and PROBOSQUE (2015–2045), which support forest producers with legal ownership of their forests, and PINPEP (2010–2030), which finances smallholders *without* legal title to their forests. Government agreements with private banks also create mechanisms for complementary financing to enable further investment in SME business development.

Mozambique. In Mozambique, public institutions such as the Centre for Promotion of Investment (CPI), the Centre for Promotion of Agriculture (CEPAGRI), the Institute of SMEs (IPEME), the Fund for Agriculture Development (FDA) and the Cabinet for Promotion of Investment (GAPI) all promote development funding for forest-linked SMEs. The mandate of these institutions

Early financial viability is critical to reassure investors they will achieve the returns required

Figure 1. Six elements that determine willingness to give or receive financing for small and medium enterprises



includes attracting investments through fiscal and non-fiscal incentives, providing capacity building around business management, and direct lending to forest-linked SMEs at relatively affordable interest rates.

Private and international finance in the national context. Development agencies, national governments, the World Bank and others provide targeted finance to support initial investment in forest-linked value chains. REDD+ financing, particularly in the case of Mozambique, contributes to creating business readiness. The effectiveness of this mechanism, however, is contingent on securing additional investment (including from the private sector) to support the running and development of the enterprise. Private finance in both countries comes mainly from commercial banks.

Barriers to financing forest-linked SMEs: investors' yardsticks and beneficiary constraints

Figure 1 illustrates the six key barriers to sustainable financing of SMEs: interest rates, rate of return, repayment period, scale, risk and grace period for loan repayment.

Risk is key

These factors were explored in interviews, discussions and other research, which showed that risk appears to be the overarching decision-making factor for both the investor in offering, and the SMEs in accepting, finance.

Collateral. Lenders often want to minimise risk with appropriate collateral for the loan, with preference for physical assets such as land, while SMEs tend to be averse to using the latter as collateral. In Mozambique for instance, all land belongs to the state and cannot be sold or used to guarantee finance, which poses an important limitation to raising collateral.

Formalisation of enterprise. Risk can include the difficulty posed by lenders' demand that the enterprise is registered as a legal entity. In Mozambique, a government one-stop shop aims to provide a non-bureaucratic process for registering businesses.

Business capacity. Another element of risk is poor management capacity, which is a barrier to both lenders and to the successful development of SMEs. In Guatemala, the National Forest Institute (INAB) has developed an online information management system that allows enterprises to record income and expenditure.

Other risks. Other risks include corruption and illegal logging, enabled by weak monitoring and law-enforcement capacity; volatile markets, for example the dramatic increase in the timber trade with China; the frequency and incidence of fire that damages forest stock; vulnerability of rain-fed agriculture; extreme weather events; and crop failure.

Such risks have sometimes led SMEs to refuse even low interest loans with a two-year grace period before repayment is required for fear they may not be able to repay the capital.

Low repayment of funds by SMEs has led government institutions such as CEPAGRI in Mozambique to focus on capacity development instead of giving loans. But such capacity building needs to be done at scale to build a viable SME sector.

For SMEs

- **Interest rates.** The prime rate in Mozambique, for example, is 23.5 per cent, which means the lending rate can be 25 per cent or more. This is prohibitive for most SMEs. In Guatemala, the rates average 14 per cent, but smallholders are still reluctant to take the risk
- **Rate of return.** Lack of infrastructure such as roads to take goods to market can hamper business development and generate additional costs for SMEs; lack of irrigation limits the capacity to increase agricultural productivity; and limited access to electricity limits the development of enterprises such as timber processing
- **Repayment period.** The repayment period is often too short for SMEs to manage, but where businesses are successful, advance payment of loans is not accepted by lenders,

Box 1. Lessons from the Global Landscape Investment Forum

During the Global Landscape Investment Forum in June 2016, both public and private funders showed a growing commitment to providing climate-smart funding. Potential funders, however, stressed the need for investment propositions that offered profitability and scale. Delegates also discussed the need to aggregate small, dispersed production units to minimise transaction costs and the need for measures to mitigate the risks faced by SMEs. The experience of Total Land Care in Malawi, which was shared with delegates, showed that 'scale' can be built progressively if adequate support is provided in the form of training, information, green technologies, access to markets and finance. Having started with 2,000 farmers, Total Land Care (www.totallandcare.org) now benefits 200,000, and 85 per cent of loans are repaid despite very high interest rates.

Box 2. Examples of positive practice

Despite the barriers, there are some examples of success. The Mozambican company, Sotomane, has successfully developed a thriving business in forestry and agriculture.

The company secured private finance from its own funds and commercial banks, and, later, public finance from FINAGRO, and was able to develop its business management capacity. It then undertook diversification of activities including forestry and agriculture, and vertical integration of product chains comprising logging and value addition into final products. Contracts with government and private contractors building social infrastructure provided a secure market for the timber, while reinvesting profits has allowed the business to grow.

hindering the capacity of enterprises to secure additional loans to grow their business

- **Scale of investment.** Some institutions such as FINAGRO (funded by the Mozambique government and USAID) provide 70 per cent of capital and require SMEs to raise 30 per cent from commercial banks or other sources. Some commercial banks follow the same approach. The need to secure such co-funding affects even relatively successful businesses (Box 1) and can limit the uptake of loans
- **Grace period.** Often SMEs require a grace period of at least a year to ensure viability and capacity for repayment, but this may be overlooked by lenders.

For financing institutions

- **Interest rates.** Commercial banks charge higher interest rates to SMEs (by around 1–2 per cent) than to larger businesses, which restricts access to credit. Lenders also prefer high-value fixed assets such as land and houses as collateral, which means even the comparatively favourable interest rates of 14–18 per cent offered by GAPI are not taken up by SMEs.

Looking to the future

Both Guatemala and Mozambique register increasing public investment to support forest-linked SMEs, including in building their business and management capacity, which helps to offset initial risk, establish viable enterprises, and unlock private and international finance — and there are some positive examples of success (see Box 2). But more needs to be done.

Enhanced capacity building. National government agencies should support *comprehensive capacity building* to forest-linked

SMEs, which should include planning and management of land and forest resources, business development training, and training in good social and environmental practices. A network of qualified and credible service providers should be established and supported to provide long-term financial services, ongoing training, technical assistance, and monitoring of enterprises based on social, economic and environmental performance indicators.

Environmental impacts. It is vital that mitigation of negative environmental impacts and building resilience to climate impacts are factored into business planning and operations to ensure sustainable and inclusive enterprises, but evidence from our research indicates that this needs to be strengthened. Appropriate performance indicators need to be defined and measured to ensure SMEs meet their climate change commitments and have a sustainable future.

Social impacts. It is also vital that enterprises consider the social impacts of their operations and promote social inclusion. Deforestation and forced resettlement of communities creates exclusion and impoverishment, and can lead to conflict — all of which undermines both the business and the realisation of the SDGs. Again, social inclusion measuring and reporting should promote business policies and practice that have a positive social impact.

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Knowledge Products

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Notes

¹ CIFOR (2015) Investment in sustainable landscapes: Time to take the risk. <http://blog.cifor.org/28865/investment-in-sustainable-landscapes-time-to-take-the-risk/> / ² Nhantumbo, I *et al.* (2015) REDD+ and the private sector: tapping into domestic markets. IIED, London. <http://pubs.iied.org/17319IIED/> / ³ Steele, P *et al.* (2015) Beyond loans: instruments to ensure the poor access climate and development finance. IIED, London. <http://pubs.iied.org/17318IIED/> / ⁴ Bolin, A *et al.* (eds) (2016) Securing forest business: A risk management toolkit for locally controlled forest businesses. IIED, London. <http://pubs.iied.org/13583IIED/>