Financing More Sustainable Forestry and Forest Related Sectors

Objectives and Methodologies:

Findings are based on two assessment surveys and desk research. The first survey examined capital needs of selected GFTN forest participant companies in SE Asia, Latin America, and Africa in order to achieve and maintain credible certification.

The second survey of over 40 international and domestic financial institutions (FI)s identified types of institutions and mechanisms that play key roles in investing in the forest products sector in Malaysia, Indonesia, Vietnam, Peru, Bolivia, Brazil, Ghana, and Cameroon.

The Role of Finance:

- Finance underpins forestry and forest related sectors (F&FRS).
- Wide range of financial products and services available and new products with a sustainability focus are emerging.
- A range of finance is available in the key countries that were part of these studies[1] provided that forest sector businesses can satisfy financing criteria (i.e. but this is often weighted heavily in favour of FI and therefore unattractive to companies).

Opportunities:

- **Small costs, big conservation results:** Forest companies surveyed were small (average annual turnover of US$ 10.8 million). They do not need a lot of money to get and maintain certification (average investment of US$ 77,000), but 69% have a difficult time securing adequate financing to achieve certification.
- **Finance through the value chain:** Value chain financing[2] may "buy down" risks and make these companies more attractive and increase competition.
- **Low hanging fruit:** FIs reported a lack of compelling sustainable forestry business proposals as a key barrier to increased financing. Forestry participants in the first survey identified this as an area in need of improvement. Technical assistance and "clearing house" platforms might more effectively match proposals with prospective backers and increase the number and quality of funding proposals being presented for screening.

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[1] Malaysia, Indonesia, Vietnam, Peru, Bolivia, Brazil, Ghana, and Cameroon

[2] Value chain financing here refers to financing that is enabled or delivered by actors in value chains. i.e a saw mill might pre finance the activities of forestry management units that were not under its direct control as a way of securing sales and enabling the FMUs to operate in advance of felling / payment for timber

- **Key innovations:** Sustainable trade finance and forestry carbon are gaining ground– but both are niche activities
- **Leveraged lending:** Multi- and bi-lateral development finance institutions play a key role – their role in co-financing of forestry is often instrumental in leveraging private capital into the sector.

<u>**Challenges of Accessing or Deploying Finance:**</u>

- **A small and unattractive universe of opportunities** Lack of commercially viable proposals is a constraint for all types of FI.
- **Commercial risk currently outweighs Environmental Social and Goverance risk:** Sustainability performance is one of many issues considered and invariably is not the key issue or generally a major factor in lending or investment. Country risk, weak management, illegality, lack of suitable collateral, weak business planning and skills, lack of (local) demand (for sustainable products and services) combine to overwhelm the case for responsible forest finance.
- **Some F&FRS companies are not bankable under any conditions:** Given the conditions in which they operate some tropical forestry businesses may never get finance.
- **Location and country are key:**
    - Countries with weak governance, weak forest law regulations or implementation will not be attractive. Lacey and FLEGT will only exacerbate this challenge.
    - FIs identified Brazil and Indonesia as attractive which may be attributed to BRIC development and future REDD opportunities.
- **Big is beautiful:**
    - Few investors consider opportunities <US$10m.
    - Banks often do not proactively lend below $10m (even development finance institutions have thresholds of 5 million +)
    - Larger timber processors have the widest access to finance – equity, debt and/or trade finance – on the basis of their ready collateral and cash flow.
    - Equity is available for suitable large scale forest management and REDD/conservation projects. But transaction costs may be very high (for example from project development, verification and M and E costs)
- **Start-ups and SME considered highest risk**:
    - Commercial banks favour established businesses; their established client base, ready assets and cash flow all lower their risk profile.
    - Microfinance and donor funding provides some support to the individual forest entrepreneurs.
    - Local banks, the preferential source of capital for SME and community based forest businesses, consider most prospective F&FRS clients to be very high risk, and set their terms accordingly
- **It's a jungle out there:**
    - Plantations trump natural forest investments and are considered safer investments due to higher levels of control/management, production capacity, efficiency, and generally larger scale.

    - Commercial lenders can finance capital investment in natural forest plant and equipment but reputation risk associated with all types of tropical forest management is a key challenge.
- **Collateral is king:** Commercial banks, in particular domestic banks, accept a very limited range of forest assets as collateral. Most significantly they are highly unlikely to accept standing timber.

International vs Domestic:

- Overall financing of F&FRS is particularly thin amongst domestic banks, especially in comparison to coverage of agricultural lending.
- Domestic banks have very little incentive for applying Environmental, Social and Governance (ESG) screening to the forestry sector – they are less brand sensitive and are currently picking up business from disaffected ex-clients of International commercial banks.
- Although they are believed to be a significant source of capital for forestry SMEs domestic banks are generally unwilling to accept forest-related assets as collateral. Lending depends on the availability of other (often personal) security.

Screening:

- **Screening for Environmental Social and Governance Aspects adds cost**:
    - ESG screening tools are the principal means by which FIs identify, quantify and address the risks associated with financing potentially unsustainable activities in the tropical forestry sector.
    - The application of ESG screening tools and investment criteria varies widely (with the most significant difference between international and domestic banks). The former increasingly have policies in place to minimise the risk of financing unsustainable activities (though implementation and consistency are a challenge), policies in the latter group (if even evident) are generally unable to assure ESG performance of loans (and typically focus on direct impacts of the FI)
- **But the importance of ESG is growing:** As a process ESG screening complements a growing range of revenue generating and enhancing opportunities that sustainable management can offer, from higher value certified timber to carbon credits and payment for ecosystem services.

Sustainability and Certification – How Important is it in the Value Proposition of F&FRS and How important in the Decision making of FIs:

- **Stepwise certification is gathering pace:**
    - Many investors do not invest unless a prospective asset is “certification ready” and half of those surveyed would use FSC certification to screen;
    - Roughly two thirds of those institutions that did not require FSC conditionality are interested in working with WWF GFTN on screening tools.
- Company size and position in the value chain, the degree of integration along the chain, market connection and end sales are the driving factors for certification and also major factors in securing needed finance.

- Large companies rely on internal financing for certification, as do small companies but mostly because they do not succeed in mobilizing external financing. Small companies especially have difficulties in raising capital for certification.