

# Institutional investment in sustainable forestry

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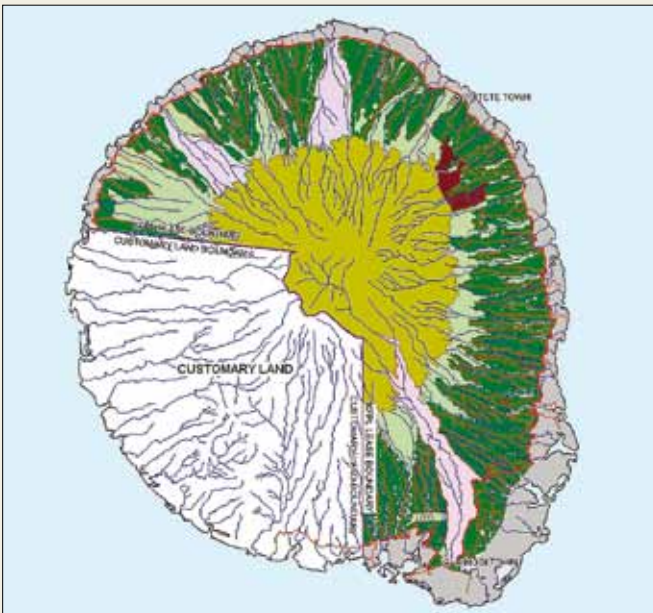
**I**nvestors acquire forests or ‘timberland’ to generate long-term returns from both the sale of harvested timber as income and the capital appreciation from biological growth of the tree crop.<sup>1</sup> Forestry investment by institutional investors has grown steadily since the 1980s, and it is estimated that approximately US\$48-60 billion has now been invested by pension funds, insurance companies, foundations, endowments, and sovereign wealth funds.<sup>2</sup> This growth in forestry investment has come about because the annual returns tend to show low volatility, have limited correlation with other asset classes, and a positive correlation with inflation, and also due to the fact that long-term investment in relatively illiquid assets such as forests provides a good match for the long-term nature of most institutional investor liabilities. Therefore forestry or timberland can provide both portfolio diversification benefits and a hedge against inflation.

Institutional investment in forests largely originated in the United States, where the bulk of invested capital remains today; however, in recent years the forestry asset class has expanded internationally. An increasing amount of institutional capital is directed to Latin America, Australia, New Zealand, and now also Eastern Europe, Asia, and Africa. As the level of investor interest has grown, specialist fund managers have emerged to offer regionally focused investments and also thematic funds focused on particular species or niche investment strategies. Such focused and thematic investment strategies offer the potential to harness institutional capital to support the expansion of sustainable forestry in key new markets. New Forests<sup>3</sup> expects institutional investors will play an important role in defining the future of the forestry sector, including bringing an emphasis on sustainability, placing capital in new regions with new market opportunities, and bringing new technology and management know-how to emerging markets.

## Investor demand for sustainable forestry

Through its interactions with institutional investors, New Forests has seen an increasing emphasis on the ways that managers integrate environmental and social sustainability into their investment strategies. Generally speaking, institutional investors are paying increased attention to environmental, social and governance (ESG) factors throughout their investment portfolios, including in research and analysis, manager selection due diligence, reporting requirements, and operational management guidelines or standards. Some of these investors may be concerned that potential investments in real assets, such as timber, agriculture, natural resources extraction, energy, and infrastructure, may have negative social and environmental impacts. These negative effects may create significant risks for project cash flows as well as wider reputational risk for the investors. In order to help manage these risks, some investors require their managers to become signatories to the United Nations Principles for Responsible Investment (UN PRI),<sup>4</sup> develop comprehensive ESG policies and ensure their investments adhere to strict performance standards such as those developed by the IFC, Forest Stewardship Council or PEFC. Some investors are taking a long-term view and actively looking to invest in assets that may hedge against the potential impacts of climate change or

The island of Kolombangara



The island of Kolombangara in the Solomon Islands demonstrates a mixed use land use system that combines production, conservation, and community land use zones in geographically distinct areas. Kolombangara Forest Products Limited (KFPL) holds a lease over approximately three-quarters of the island

Source: KFPL



Image: KFPL

An excavator bunches logs and prepares them for loading onto a truck at Kolombangara Forest Products Limited

the increasing expectation of a price on greenhouse gas emissions. For example, a recent report published by the Mercer consulting group on climate change indicates that in some cases the best way to manage portfolio risk from climate change is to increase exposure to assets that are less susceptible to the effects of climate change and that are capable of adapting to low carbon development, such as forestry.<sup>5</sup>

For investors with such sustainability objectives, New Forests believes investment into certified, sustainable forest plantations can be an important addition to a portfolio seeking to strengthen ESG performance. Forest certification involves independent third-party verification of environmentally and socially responsible forestry practices and log tracking systems. Ultimately, forest certification can improve forest management and add value to existing assets by:

- Boosting cash flows, e.g. by securing a certification price premium on wood destined for environmentally sensitive end markets or by increasing operating efficiencies and reducing unit costs of production.
- Reducing the riskiness of cash flows, e.g. by improving relationships with local communities and other stakeholders thereby reducing external disruptions to operations.
- Increasing asset liquidity and value, e.g. by making forest management more transparent, asset managers can reduce information asymmetries between buyer and seller and enable buyers to use a lower discount rate for asset valuation, and strong environmental and social performance will attract a wider pool of potential buyers.

Forestry investment offers substantial opportunity to integrate ESG concerns throughout the investment process, and not just in the physical operations. Some of the key sustainability factors that may attract institutional investors include:

- The role of forestry and land use in mitigating and adapting to climate change, particularly for forests to sequester and store carbon in trees and soil, and for biomass energy systems
- Meeting growing global wood demand without compromising the future supply of natural resources
- Ensuring the provisioning of ecosystem services, including habitat for important wildlife species and functioning hydrological systems
- Increasing rural employment opportunities and supporting related local livelihoods.

#### **Socio-environmental co-benefits of forestry investment**

##### *Environment and biodiversity*

It is estimated that more than two thirds of the remaining tropical forests are either already subject to logging or are likely to be in the future,<sup>6</sup> and less than 10 per cent of tropical forests are in strictly protected areas. Numerous studies have shown that most plant and animal species survive selective logging as compared with conventional logging practices in the tropics.<sup>7</sup> However, biodiversity and other attributes of forests are threatened by conversion to non-forest land uses. Responsible forest management can provide local employment, revenue flows, and raw materials for processing industries. In addition, forest management can increase the value of standing forests, which confer additional socio-environmental benefits and stabilize land use pressures on native forests. Nevertheless timber harvesting in natural forests is controversial





Image: KFPL

A woman contractor plants a seedling at Kolombangara Forest Products Limited in the Solomon Islands

and most investors prefer to invest in plantations established on marginal agricultural or degraded land.

Investing in forestry may include acquisition of existing plantations or new unplanted (greenfield) plantation license areas. In some cases, particularly in Southeast Asia, this may involve assuming management responsibility for heavily degraded natural forest with residual biodiversity values. In order to maintain, restore, and enhance environmentally sensitive areas, such as residual natural forest, natural forest cover on steep slopes, riparian zones, and other high conservation value areas, forest management plans can be created that intensify production in the most suitable areas while allowing for conservation-based management in others. Depending on local circumstances, in some of the most degraded areas (e.g. non-forest or immature secondary forests regenerating following agricultural use) investors may establish fast-growing, high-value hardwood plantations. By applying this integrated approach that preserves environmental values and increases productivity, forest management plans can result in natural forest/plantation mosaic landscapes producing timber and sustaining high levels of biodiversity over the long term. Emerging environmental markets for carbon, including programmes for Reducing Emissions from Deforestation and Degradation (REDD), and biodiversity can be used to support the investment model of intensive timber production combined with protection of residual natural forest areas. Income from environmental credits can be used to offset the costs of natural forest set asides and make the combined production and conservation model commercially attractive to investors. New Forests believes this environmentally sensitive intensification is essential for meeting global wood demand while alleviating pressure on remaining natural forests.

#### *Society and Stakeholders*

While institutional investment seeks primarily to generate returns that meet medium to long-term financial liabilities, forestry investment presents economic opportunities that also reach local stakeholders, including communities and governments. This is particularly true in emerging markets, where natural resource industries play a significant role in development. Forestry investment in these areas offers a sustainable development pathway that brings revenue and livelihoods.

In remote areas and developing countries, rural community development is often tightly linked with the health and use of forest ecosystems. ESG integration can be useful in ensuring local rights are respected and reinforced. Investors can utilize specialized consultants and established processes such as free, prior and informed consent and high conservation value area assessments<sup>8</sup> to help assess and address these local stakeholder needs. For example, areas that have high cultural significance can be preserved for the long term when incorporated into a landscape system that diverts timber production and plantation development to degraded or less sensitive areas. However, in some cases local community needs may be incompatible with some types of intensive forestry, and investors following strong ESG and sustainability guidelines will be capable of identifying appropriate areas for investment.

Institutional investment also brings funding directly into local economies and can support livelihoods and local stakeholders. Employment is created through onsite operational activities, and regional or local specialist forest



Image: KFPL

Logs are loaded for shipping from the Solomon Islands to Viet Nam, sold to a furniture manufacturer seeking FSC-certified timber

managers contribute valuable expertise. FSC and other forestry certification schemes ensure that relevant labor guidelines and laws are enforced to promote worker health and safety. These labour guidelines also help ensure that employment is legal and non-exploitative. Additional livelihoods are sustained through indirect economic impacts, such as secondary processing and export-oriented activities. While the above benefits are important for supporting stakeholders and promoting livelihoods, forestry investors must be aware of potential negative impacts. It is possible that increasing incomes in rural areas can lead to social conflicts due to changes in community power structures, local inflation, and increased migration pressures.

### Conclusion

The case of KFPL is an early example of the potential for institutional capital to generate attractive and stable investment returns while at the same time creating and sustaining positive social and environmental outcomes within the forestry sector as an emerging markets. As the responsible investment movement matures, more and more investors are looking beyond merely avoiding negative social and environmental impacts associated with their investments; these investors are now actively seeking opportunities to catalyze sustainable outcomes. With direct connection to ecosystems, consumer goods, and rural livelihoods, the forestry industry offers ample potential for such sustainability-oriented investing. At the same time, the socio-environmental management of forest areas and plantations can directly improve the bottom line via risk mitigation, increased efficiency and long-term asset appreciation. As institutional investment in timberland expands its reach beyond the North American market, these opportunities for aligning commercial and socio-environmental returns are becoming more pronounced and allowing for transformative investment strategies in the forest sector.

### Kolombangara Forests Products Limited



Image: KFPL

A KFPL employee near a 20-year old plantation eucalyptus tree about to be harvested near the edge of the buffer reserve

The case of Kolombangara Forest Products Limited (KFPL) in the Solomon Islands demonstrates how private capital and a sustainable investment approach can yield substantial benefits. KFPL was established in 1989 by the Government of the Solomon Islands (represented by the Investment Corporation of the Solomon Islands or 'ICSI') and the United Kingdom's development finance institution, then known as the Commonwealth Development Corporation or 'CDC'. While the Solomon Islands have experienced widespread harvesting of their native tropical forests, KFPL was created as an example of integrated conservation and development. The 39,000-hectare KFPL estate comprises 12,000 hectares of hardwood plantations, including gmelina eucalyptus, teak, mahogany and others species, and over 25,000 hectares of natural rainforest under conservation and natural forest management. KFPL's operations achieved FSC certification in 1998, the first in the Pacific Islands.

In 2006, a majority shareholder position in KFPL was acquired by New Forests on behalf of an American investment fund, and CDC (at that stage renamed CDC Group Plc) exited the investment. The new deal was supported by a grant that enabled the Investment Corporation of the Solomons Islands to maintain their share in the company. At that time, KFPL employed more than 200 people with approximately 700 additional employment positions for contractors. KFPL's status as a producer of FSC wood was a critical factor in the acquisition, as it provided assurances on social and environmental management to the institutional investors.

The 2006 investment provided additional capital resources to help the plantation company meet its potential as a producer of tropical plantation hardwoods. The investor looked at long-term strategies and was able to cover short-term debt enabling KFPL to invest in new equipment and resources to improve its production and become more efficient. The new investor was also able to bring the latest forest management expertise drawing from worldwide experience to modernize the systems at KFPL. This included improved description of the resource, updating the forest information, account systems, databases to enable accurate analysis and reporting. These measures enabled better strategic and operational decision making that ultimately improved the asset value and ensured that KFPL remained a strong example of sustainable forestry investment yielding multiple local benefits.