Green Investment and Growing Our Natural Assets

Keynote speech by David Brand, CEO of New Forests

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Distinguished guests, ladies and gentlemen, it is a pleasure to be here with you today. My thanks to the organizers for the invitation to speak on the emerging demand for green investment and natural capital.

I would like to begin by briefly introducing our company New Forests. We are an investment management business for institutional investors—pension funds, insurance companies, fund of fund investors, development banks, and endowments. We manage commingled unlisted funds that invest in forestry plantations and forest conservation as well as some infrastructure and processing assets. Our firm is ten years old and we manage a little over USD 2 billion in assets in Australia, New Zealand, Malaysia, Indonesia, and the United States. We are the only investment manager who has raised a dedicated fund to invest in forestry plantations in Southeast Asia. Our Tropical Asia Forest Fund is a USD 170 million fund, and is now approximately half invested in Malaysia and Indonesia. In Sabah, we also manage the Malua Biobank, which is a pioneering venture to monetize the restoration and conservation of 34,000 hectares of lowland dipterocarp forest for biodiversity values.

As a company we seek to invest in landscapes and deliver both intensified production and conservation outcomes. We also are committed to the concept of shared value, where we see benefits to the communities where we operate to be of equal importance to the returns to our clients.

Before I turn to the specific challenges and opportunities in Asia, I would like to outline our view of the five big trends affecting the global forestry sector today.

The first is the rise of Asia as the primary source of demand growth. If we look back ten years ago, the US and European markets were the centre of demand for wood products, including both pulp and paper and lumber for housing construction. Today China is the largest importer of logs and lumber and rivals Japan as the largest importer of hardwood woodchips. That has created a restructure in international timber markets. As investors, exposure to Asian demand growth is a key element of our investment strategy.

The second trend is the systematic shift in world timber supply from harvesting extensive natural forests to intensively managed timber plantations. While there is not a bright line distinction between what is a plantation and what is natural forest management, our current best estimate is that the world produces about 1 billion cubic metres of timber from natural forest harvesting and 700 million cubic metres from timber plantations. When we look at future supply, it appears evident that natural forest harvest will be flat or slightly declining and all incremental supply will come from plantations, primarily in the Southern Hemisphere and tropics. That means if all supply will come from plantations and all incremental demand will come from Asia, then timber plantations supplying Asian demand would seem to be a good investment opportunity.

The third trend relates to the significant, and even disruptive, shifts occurring in markets. Ten years ago there was no iPad or iPhone, and people read newspapers. Today newsprint production has declined, and even printing and writing papers are showing a decrease in demand. However, alongside this has been the emergence of the so-called bio-economy, where forestry biomass is being used for energy, fuels, fabrics, platform chemicals, and resulting bio-plastics. Global action on climate change is also stimulating public policy and research into technologies to replace fossils fuels, fossil energy, and petrochemicals with bio-based alternatives. Again from an investment perspective, many of the institutional investors who are setting targets to move away from fossil energy investments or to reduce greenhouse gas emissions are seeing the forest sector as one of the areas where they should actually expand investments.

Which leads me to the fourth big trend affecting the forestry sector, and that is the rise of institutional investment in forestry and the declining role of government. Since the 1990s investment portfolio theory has really advanced. Simulation models combine a range of different assets and project the expected returns and volatility into the future. As a result of this there has been a shift in portfolio allocations toward stable long term 'real assets.' This includes real estate, infrastructure, forestry, and agriculture. In fact it has been suggested that real assets represented about 5% of institutional portfolios in the 1990s, probably represent about 15% today, and will likely reach 25% in the decade. There is already $100 billion of institutional investment in forestry and tens of billions of dollars more capital available for forestry investment.

Finally, is the rise of the emphasis, even an imperative for investment outcomes to be socially beneficial and environmentally sustainable. I would include in this final trend the search for ways to value ecosystems and ecosystem services. Our clients want nothing to do with investments that have negative social or environmental outcomes, which are poorly governed, or exposed to corrupt or unethical business practices. We need independent third party certification and active engagement with the communities where we operate. This tends to also lead us to look at production systems such as timber plantations and conservation of natural ecosystems as two sides of the same coin. We manage over 400,000 hectares of timber plantations, but also launched the first Eco Products fund and operate the largest investment business related to California Carbon Offsets from forest conservation.

These five trends all affect how forestry will evolve in Asia. The era of timber production coming from the frontiers of natural forest is largely over, and we see a rising timber plantation base in places like Vietnam, Thailand, China, Indonesia, and Malaysia Some of the early plantation development projects were financed by the World Bank, often in partnership with governments. More recently plantation establishment has been privately financed by both smallholders as well as large corporations. Our new Asian fund signals that there is just the beginning of institutional investor participation in the sector. There has been substantial concern that private plantation developments have not operated on a sustainable basis, and that conversion of High Conservation Value Forests, lack of community engagement, and murky business dealings have dogged some operations.

But I believe that this is changing now for the better. Companies involved in plantation development have been encouraged to move away from unsustainable practices by their markets, by their investors and by their financiers. We now have substantial pressure for companies to use external certification processes, to make commitments to going deforestation free, and to be externally audited against those commitments. This means that conversion of new areas of natural forest to plantations will decline, and the emphasis will be on plantation establishment on truly degraded land, or increases in productivity on existing plantation areas. In fact it is our view that plantation productivity should be increased substantially. Examples from agriculture and timber plantation systems in other regions such as the United States, Australia, and New Zealand suggest that productivity has been increasing by 1.5% per annum for several decades. If demand grows by 1.5% to 2.5% per annum, which is a reasonable expectation, much of the supply needed to meet this demand can come from productivity improvements rather than plantation area expansion.

Of course increased investment in plantations doesn't support the financial needs of conservation in the remaining natural forests. We need to expand the discipline of conservation finance and find ways of introducing some of the international success stories to Asia. For example we have invested in a range of environmental and conservation finance instruments ranging from wetland and stream mitigation banks in the United States, nutrient credit trading, California forest carbon offsets, conservation easements, tradable water rights, and biodiversity offsets. Some of these instruments are reaching scale—wetlands mitigation banking in the USA turns over $60 to $80 million in credit sales per annum, the California carbon market is expected to produce demand for $2 to $3 billion of carbon offsets by 2020, most of which will come from forest conservation.

In Asia we have been waiting for years to see whether a REDD+ instrument that could sustain private conservation investment would emerge and years for a compensation mechanism under the RSPO to provide funding for biodiversity conservation and restoration. In the meantime, oil palm plantations are valued at up to $20,000 per hectare, rubber plantations at $10,000 per hectare, and even pulpwood plantations at $2,000 per hectare. Natural forest logging concessions on the other hand are worth $300 to $500 per hectare. In economic terms that creates a profit to those who convert forests to plantations. The ultimate end game needs to be price signals for ecosystem services such as carbon storage, watershed conservation, and biodiversity values. As a company we are keen to see investment returns from both production and conservation outcomes. Our Asian fund even has a facility from the Dutch Development Bank FMO to support carbon or biodiversity investment opportunities alongside our timber plantation investments. To date we haven't been able to draw on that facility because there has not been a market for these conservation values.

When we look at investing in the Asian forestry sector there are great opportunities, but also impediments. One of the issues that I find quite challenging is the confusion over land and land use rights. Often there is a licence for a plantation area but many people living on the land, which can lead to disputes among indigenous groups, migrants, and licence holders about who has rights to what. This makes large areas of Asia un-investible because of uncertain property rights. While we are willing to look at concepts of shared rights with local communities as well opportunities for joint ventures and negotiated agreements, it is typically seen to increase investment risk and raise the returns needed to justify investment. We also have to factor in broader business risks, such as access to fair legal adjudication of contract disputes or property rights, consistency in legislation, tax rules, and foreign investment policies. Finally, we need to face higher economic and political risks, including corruption, poor labour standards, conflicts at community level, lack of infrastructure, and lack of managerial capacity.

Of course as investors it is our job to understand those risks and manage them. We seek to work with local partners who can understand our requirements and facilitate implementation of projects that meet our sustainable and responsible investment objectives, and who can bring local management expertise. We also utilize community mapping and free prior and informed consent processes to ensure we understand the local community aspirations and to help resolve outstanding disputes. And finally we use independent third-party certification of our operations to ensure we are transparently meeting our investment goals. As a fund manager we also seek to make several investments to diversify our risk and generate a portfolio with different market exposures and risk factors.

If I come back to where I started, there are opportunities for investors in Asian forestry, because Asia is the source of demand growth and potentially part of the source of increased wood supply from timber plantations. There is substantial investment capital seeking to invest in forestry plantations on a sustainable and responsible basis, and a rising opportunity for that investment to support both timber production and forest conservation. However, the rate at which investment will flow into Asian forestry, at least from institutional investors, will be a function of how well governments can establish fair and clear land use rights, reliable legal systems, and stable investment policies. As well, the area of conservation finance will need further development including a REDD+ mechanism to generate a return to private investors in conservation, and potentially other mechanisms like compensation, offsets, tradable rights to ecosystem services, and conservation easements or conservation licences.

Thank you.