

Stimulating private investment in the forestry sector

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Deforestation has devastating effects in developing countries. Managed sustainably, forestry projects provide solutions to economic, environmental and social problems by creating jobs, developing infrastructure, etc. Through the financing of forestry projects, development finance institutions can have a favourable impact on local legislation, as well as providing reassurance to investors.

Natural forests are disappearing fast globally. Every year global forest cover reduces by some 10 million hectares. The majority of this occurs in the Southern hemisphere and in developing countries.

Forests serve as a natural carbon storage area – as a tree grows, it sequesters carbon. Deforestation is one of the key contributors to climate change, and has far-reaching implications for the environment in several ways – deforested areas are prone to drought, as the vegetative cover protecting water sources is removed.

They are also prone to erosion and depletion of soil minerals and significant losses of biodiversity and ecosystem services. Deforested areas suffer more easily from other catastrophes such as flooding and landslides, and in the longer term, deforested areas can undergo desertification, no longer being able to provide livelihoods for local people. Measures to reduce deforestation have a positive impact in the fight against climate change. Beside climate change has already demonstrated devastating impacts in developing countries. Most are located in the tropical and subtropical regions where even small changes in climatic conditions have large consequences. The people in these countries are poor and highly dependent on natural resources, agriculture and other such sectors that are sensitive to climatic changes.

In developing countries, especially in Africa, a major contributor to deforestation is demand for firewood, as well as shifting agricultural practices. Protecting existing forests alone is not sufficient to fight deforestation. If alternative sources of firewood (or charcoal) and inputs needed for improved agricultural practices are not provided, the protection efforts may become futile, as the people will move to another location where protection is not enforced, and the deforestation will continue.

Promoting the sustainable management and use of forests by providing education and technical support as well as developing new forest resources are equally important as conservation.

Depending on the end use, new resources can be developed through rehabilitating degraded or badly managed forests or by planting new forests. While plantation forestry may in some stakeholders' minds have a negative connotation, it can yield significant positive environmental and development effects when implemented appropriately. Forestry projects take time to develop though, and the attached community and social development issues require close monitoring, time, support and effort.

In developing countries where political and country risk issues limit the appetite of private sector

investors and financiers, the long-term commitment required in these projects may further reduce the attractiveness of the sector. Further, infrastructure challenges in these countries make these projects more expensive, lowering the yield. Thus, there is a clear need for development finance institutions and multinationals to participate in this sector, as catalysts to other funding.

Forestry is one of Finland's development policy themes, and regarding the sustainable use and protection of forests, Finland and the developing countries share the same goals. Forestry offers economic opportunities and social and environmental benefits. By providing a framework for sustainable forestry, equitable economic growth is created, poverty is reduced, and threats to the environment are prevented. Finnfund is one of the instruments for implementing Finland's development policy, and it has established a dedicated team to review opportunities in this area.

Forestry and development impacts

Development finance institutions such as Finnfund require their investments to be both profitable and to generate measurable development impacts in the project country. In addition to effectively mitigating climate change, forestry projects also provide a wide range of these development impacts.

Forestry projects tend to be located in rural areas where formal employment opportunities are few, they are labour intensive - a large project easily employs thousands of people - and many tasks are manual. Employment requirements range from the performance of simple tasks to more demanding positions. Women are equally easily employable. This large employee base supports the development of additional economic activities, providing livelihoods for even more people.

This potentially improves resilience and supports adaptation to the effects of climate change.

Forestry projects require infrastructure, both in their immediate area and from the project site to markets, and most projects invest heavily in developing and maintaining it. As the project sites tend to be very large, the whole region generally benefits from this.

While the land use and tenure regulations of the relevant country determine whether forestry projects will be based on land ownership or other types of tenure, they typically make some form of payment either to the government or to local agencies or communities for the use of the land and wood. The projects also contribute to the local economy through direct and indirect taxes and in other ways. Wood products often have significant export value, have well-developed global markets, and can provide significant export revenues to the country.

Well-managed, legally operating plantation forestry projects help battle illegal logging. They contribute to the development of official and legal wood product markets, and meet the demand that illegal logging attempts to satisfy. They help officials and governments as well as local people to understand the benefits of legally operating projects, and thus make the operations of illegal loggers more difficult and less profitable.

Properly implemented plantation forestry projects set an example of good governance and may help host countries to develop sustainable forestry policies.

In Finnfund's experience, forestry projects have provided the significant development impacts expected of them. As an example, Finnfund has been an investor in a teak project in Tanzania for more than ten years. This company supports the people within its area in many ways. For example, it has financed schools and health care, and now provides jobs for several hundred people in one of the poorest areas in Tanzania. When harvesting and processing get into full swing, several thousand jobs will be generated directly and indirectly. When the wood trade and processing are established, teak looks set to become an important crop plant for the area and a major export product for Tanzania, providing over 130 million dollars of export revenues over a ten-year period.

Unfortunately, where a business fails, the developmental impacts are largely lost as well. During its history of forestry projects, Finnfund has experienced one such failed project. In that case, the

failure was mainly caused by changes in the political and operating environment that made it impossible to have staff on the ground and to continue to develop the project. In some other projects where the business has developed slower than expected, significant values are still captured in the growing biological assets, and while the overall returns of the project will be negatively impacted, the developmental impacts are still significant.

Finnfund's investment criteria in forestry and forestry-related projects

Due to the significance of the forestry sector for Finland's economy¹, its technical know-how² and the expected development and environmental benefits delivered by the sector, it follows that this is also one of the focus sectors for Finnfund. Forestry projects to the end of 2011 accounted for some 20 % of Finnfund's portfolio.

Finnfund's investment criteria for forestry projects do not, as a framework, differ from those of other sectors. Key criteria include profitability, private sector participation, environmental and social sustainability, development impacts, good governance and the integrity of other project parties. However, in forestry projects and in projects which have similar land use issues (such as biomass projects), certain aspects of the project receive in-depth scrutiny in due diligence and on-going monitoring, due to their complex and sensitive nature. Typically, the due diligence follows the requirements set out in the IFC Performance Standards and forestry certification, and preferably the Forest Stewardship Council criteria.

Especially in new, greenfield plantation forestry projects, economic sustainability requirements may, for example, entail that land use permits, be they concession agreements or other such permits, be valid for a long enough period, and always cater for the replanting of the areas after the wood resource has been harvested. A forest management plan that is based on the sustainable development and use of the resource is also required. Social sustainability, on the other hand, may require the project to provide alternative sources for firewood, charcoal or other ecosystem products and services, or education and technical assistance in developing agriculture practices that will eventually provide the community with an alternative to, for example, slash-and-burn practices.

Land procurement and land use plans and practices receive especially detailed and in-depth analysis. This includes legal due diligence of the land procurement and use but also an analysis of the overall land tenure issues, from a legal but also cultural and customary points of view. Land use is also assessed from an alternative land use point of view, to make sure that the project will not jeopardise or restrict food production and food security, or otherwise negatively impact it, e.g. in water use. Especially in greenfield projects that are located in less-developed countries with complex land tenure issues (e.g. many African countries), increasing emphasis is given to community consultation and NGO co-operation. The underlying goal is to ensure that the projects are designed to respect areas and resources that are important for communities.

While the environmental and social aspects of the project assessment tie closely in with land use issues, conservation should be highlighted separately. The assessment includes identifying and maintaining environmental and social values that are considered to be highly significant or critically important (defined as high conservation-value forests in the IFC performance standards). Finally, projects are assessed from the point of view of the equitable use and sharing of benefits.

Finnfund has participated in both direct and indirect forestry investments in 15 countries. The average size of the investment in the forestry sector varies from 7 to 10 million dollars. Direct investments have been in both existing projects and greenfield developments as well as in the industrial components of the business, largely in frontier markets (at least as defined at the time of making the investment), where purely commercial funding is not readily available and the regulatory framework is still being developed.

Finnfund strongly believes that it is a key part of the role of development finance institutions to go

into situations where the regulatory framework has not been finalised and to help improve them, both through interaction with regulators and by showing the potential of responsible long-term private-sector investments for various stakeholders. This is particularly true in forestry.

Footnotes

¹ In the past couple of years, it has contributed 4-5 % of Finland's GDP, which is very high for the EU. More important, it generates some 18 % of Finland's export revenue.

² Finland has state-of-the-art scientific and technological knowhow in forestry, and is home to many large multinational companies in the industry. The players in the sector, including research institutes, universities and the large corporations, have been busy developing new technologies and products catering for new markets (bioenergy, other wood-based products) which will generate half of the sector's additional value created by 2030.

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