The Forests Dialogue

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Investing in Locally Controlled Forestry: Reviewing the Issues from a Financial Investment Perspective 24–25 May, 2010 | London, UK Background Paper

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EXECUTIVE SUMMARY

This paper aims to find common ground between forest rights-holders and investors, in order to improve the prospects of attracting productive investment into the locally controlled forestry sector. It attempts to unpack the issues that concern all stake-holders and identify the pre-conditions, obstacles and opportunities that define the investor's experience. The main points are as follows:

- Investors can be organized into a number of 'ideal types', firstly as 'hard' or 'soft' investors, and then by their interest in financial, social or conservation goals. Different types of investor have different needs, and these will affect how they attempt to form partnerships with local rights-holders.
- Attracting investment direct to locally controlled enterprises, rather than to large concessions or estates, yields economic, social and environmental benefits. In the context of REDD and carbon investing, ensuring the social and economic wellbeing of local people is not only the right thing to do, it may be critical in protecting the long term value of the carbon stock.
- Investing in forestry poses particular challenges to investors because of the time scales involved, the long periods before income is produced and the multiple risks that may afflict the investment before maturity. These require specific risk mitigation measures.
- Investing in community enterprises incurs very high transaction costs in relation to the amount of investment, and may be possible only if public institutions and donors co-invest with value investors in order to reduce the risk and cover the higher costs of due diligence.
- Investors and forest communities tend to agree that 'rights and tenure' is an important issue, but they may see the problem in slightly different ways. Defining the specific rights to the myriad goods that forests provide can make it difficult to distribute risks and rewards.

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- Rights-holders may need to work with governments to encapsulate their rights into a legible legal framework that permits fair use of the resource, even if this does not in the short-term advance their ultimate goal of freehold tenure.
- Value investors are interested in investing in an identifiable enterprise that has a viable business plan. The community's goals must therefore primarily be financial, even if it later decides to distribute dividends in a manner than advances social goals.
- Social and conservation investors may have multiple goals that are incompatible with running a successful and sustainable enterprise. Some of their projects may lack business focus, and could even inhibit genuine commercial enterprises from emerging in the community.
- Certain types of social investors may misunderstand the value chain and be unduly suspicious of the role of middlemen and brokers in linking communities to markets.
- Company-community partnerships should be based on profit sharing rather than paternalism, to avoid the case of local amenities being provided by Corporate Social Responsibility schemes in lieu of cash, which is non-transparent and arguably displaces public expenditure.
- Technical capacity building can be costed into a business plan and covered by the initial investment, but organizational and institutional development may need to be covered by 'soft' investment funds.
- Networks and associations of rights-holder groups could assemble portfolios of potential investment candidates, whilst producing best practice guidelines on partnerships, profit sharing, capacity building etc.
- Investors should take a strategic view of the value chain for particular products, making investments in areas that are most likely to improve the fluidity and responsiveness of the chain, such as aggregators, research and development, business development service providers, leasing companies etc.

Even though it may be carbon that is driving investors to forests—rather than a sudden desire to invest in small forest enterprises—an opportunity exists for rights-holders to demonstrate that a holistic view of forest outputs will necessarily require some strategic investment. On the other hand, investors may need to demonstrate how business goals are often compatible with achieving social and environmental objectives. Indeed, some will argue that market-based approaches are the only way to resolve the challenges that face forestry as both a public good and a local asset.

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INTRODUCTION

Research indicates there are huge opportunities to invest in small-scale forestry or community-based forestry projects to achieve a decent return on investment whilst advancing certain environmental and developmental goals. However, current financing mechanisms do not yet seem to be oriented to this sector, except in some specific and quite limited examples.

This may be caused by a mutual lack of understanding of small-scale or community forestry by the investment community and of investment by small-scale and community foresters. Nevertheless, there is shared recognition of the importance of investing in locally controlled forestry to create resilient economies that are able both to sustain and make returns from forest resources—and the interest in learning more about how to do this has been widely expressed. The goal of the Investing in Locally Controlled Forestry (ILCF) dialogue initiative is to build relationships between the stakeholders, identify the obstacles and opportunities for investment in LCF, and increase the visibility, role, and potential that locally controlled forestry can have.

This subject is highly relevant today in the context of the global effort to design models that will mitigate climate change. Market-based solutions are likely to play a leading role in any global scheme (e.g. REDD) and there is a general consensus that changing the economics of forest management is a key priority. This will attract more interest to the subject of locally controlled forestry, but not necessarily in a manner that benefits rights holders.

This document is written largely from the point of view of financial investors, but also considers the needs of investors seeking other tangible non-financial returns. Rather than make firm recommendations or draw conclusions, the purpose of this paper is to set the scene for the Fifth Dialogue by laying out some of the issues relating to ILCF, recapitulating some of the work done so far and unpacking some of the more complex and contentious issues in order to stimulate discussion between different parties.

SECTION 1: BACKGROUND

1.1 The ILCF initiative

Locally controlled forestry means *'the local right for forest owner families and communities to make decisions on commercial forest management and land use, with secure tenure rights, freedom of association and access to markets and technology.'*[1] This includes the management of forests for timber, non-timber forest products (NTFPs) and other social or environmental service values, as carried out by forest-dependent families or smallholders, community groups and Indigenous Peoples. Together these 'rights-holders' have substantial (and growing) decision-making power and control over forestland but not necessarily tenure or ownership rights. Although tropical forestry tends to dominate the debate and thus skew the focus to emerging economies, there are also 25 million forest owners in North America, Australia and Europe who fit the description of Locally Controlled Forestry.[2]

Investment, as defined in the context of the ILCF initiative, is **the active allocation of resources to enhance forestry assets not only in the present but also for future benefits.**[3] Using this definition,

investments in locally controlled forestry can be made in a variety of ways and by a variety of actors. They can be grouped under the titles of 'soft' or 'hard' investment depending upon the expectations of return on investment. For instance, investments made by donors and non-governmental organizations to improve governance or secure forest rights through tenure reform could be said to be 'soft' investments, as their expected outcomes are somewhat abstract. On the other hand, investments in creating new forest resources, managing forests, building production and processing facilities and other infrastructure are 'hard' investments as the anticipated outcome is a tangible return on the original investment. Of course this division is not always clear cut. Some institutions may make cash investments with little expectation of a financial return, but instead are seeking something measurable such as improved bio-diversity. Investment in areas such as developing human resources and capacity building, or establishing forest certification programmes for assurance of sustainability, may be on commercial terms, but they are more likely to be grant-funded in some way. In many cases 'soft' investment is required to pave the way for more commercial investment to follow. Table 1 gives in breakdown of various investment activities and their likely investor.

TABLE 1: 'HARD' AND 'SOFT' INVESTMENT

	Activity	Investor
'Hard' Investment	Creating new forest resources, managing forests, building production and processing facilities and other infrastructure, direct financial investments	- Financial investors, banks, forest companies - Governmental organizations - Small and medium forest enterprises - Resource owners and rights-holders
'Soft' Investment	Preparing the ground for 'hard' investment, e.g., improving governance, securing forest rights, developing human resources and capacity building, establishing credible forest certification for assurance of sustainability	- Multilateral organizations, Bilateral donors - Governmental organizations - Environmental and civil society non-governmental organizations - Research institutions - Resource owners and rights-holders - Forestry companies

As this paper is written from the perspective of financial investors, it will necessarily dwell on the 'hard' investment activities rather than the broader 'soft' investments. A typology of investors that fall in this category is given in the next section.

1.2 Investing in Forestry

Most land uses deliver both public and private goods, but forestry is unusual in that it presents an opportunity to extract rents that have been accrued over very long periods of time. From an investment point of view, forestry is more often seen as an extractive industry, similar to mining, rather than a sustainable land use such as agriculture. In the mining sector the aim is irrevocable transformation, with no expectation that the mineral will be returned later to the geological seam, or that it will somehow grow back. Similarly, in many areas of forestry the term used is 'forest conversion' rather than 'forest management.' The forest becomes something else (e.g., oil palm), in the meantime releasing rents

upon the felling of the trees. The long term economic value from the new land use may have very much higher income per hectare than the forest's former state.

Even in production forest concessions that are required to achieve some level of sustainable harvest (there are many arguments over what this means), industrial logging, lack of oversight and corruption may lead to a gradual degradation of the forest, until parts of it reach a state of *de facto* conversion. It should be acknowledged that even though it is inherently unsustainable and often oppressive to local rights holders, this model has satisfied many investors around the world, especially in Malaysia and Indonesia.

However, this business model ignores those externalities that usually have no price attached to them. A healthy forest provides bio-diversity, natural beauty, ecosystem services, habitat, cultural meaning etc. Its destruction may produce negative externalities such as release of stored carbon, floods and landslides. For this reason, there is now a general acceptance (if not yet widespread practice) of the principles of 'sustainable forest management' (SFM). Although this term means different things to different people, it broadly infers that the forest should be managed in such a manner as to leave the character and value of its full spectrum of services intact.

From an investor's point of view, SFM can be problematic. As Engels observed, resources are nature's free gift to capital,[4] and pricing the full economic replacement cost of the resource is counter-intuitive if considered through the lens of extraction. It is often observed that finding finance for SFM is complicated by the many outputs that can be expected from forests, some of which may be easily captured for private gain (such as timber), whereas certain externalities (carbon, watershed services) are harder to monetize.

Forestry is a long-term investment, ranging from ten years for fast growing tropical plantations, to fifty years or longer in temperate climes. In the context of complex or overlapping tenure and rights, there are problems with the distribution of costs and benefits over such timescales. For local people, this can mean they bear the costs of deferred logging while the returns from SFM accrue to global investors (or the state). For investors, SFM can be costly in terms of decreased cashflow and delayed returns. If tenure rules are unclear or capricious, both investors and local people fear they may be unable to benefit from the improved asset quality that arises out of good forest management, creating a disincentive to make the necessary long-term investments.

To sum up, the term 'investing in forestry' has usually been taken to mean 'investing in the removal and/or planting of trees.' However investors are now increasingly advised to take a more holistic view of forestry, and consider how to work with local rights holders to capture medium term cashflow whilst participating in the benefits from nurturing long term asset quality.

1.3 The case for Locally Controlled Forestry

The arguments in favour of locally controlled forestry have been well rehearsed in reports and conferences (including TFD's dialogues) and do not need to be repeated in detail here. In summary, the case for LCF (or what is also termed 'community forestry') can be viewed in terms of economic, social and environmental impact:

Economic

In both developing and developed countries, small and medium sized enterprises (SMEs), such as those set up and managed by forest rights-holders, can be the engine of economic development. Unlike the vertically integrated industrial model of forest resource management that has been the dominant paradigm for so many years, small-scale industry has specific micro-economic characteristics that generate a 'multiplier effect' in rural economies. This translates into more skilled jobs, higher incomes, higher consumption and improved terms of trade. The DFID-funded Livelihoods and Forestry Programme program in Nepal[5] indicates this effect to be approximately 10:1, but some studies calculate this multiplier effect to be as high as 20:1.[6] It is often quoted that forest communities produce $75–$100 billion/year in goods and services.[7]

Social

Local economic development, where it involves the active participation of local people, has obvious social benefits. Specialising in small enterprises (e.g. timber processing) allows households to make a smooth transition from subsistence living to the market economy. Time gained through buying food in the market instead of hunting or gathering can be spent participating in local institutions. Surplus income is often invested in health and education, improving the welfare of the next generation through better nutrition and broader horizons for fulfillment. Communities with a mosaic of locally-owned businesses tend to have more self-confidence, political influence and autonomy.

Environmental

It is a common generalisation that forest dwelling people are naturally disposed to be careful stewards of the environment, and where they do collude in the degradation of forests they do so for understandable economic reasons (the 'poverty causes deforestation' argument). This may not be entirely accurate for all people in all places (just as generalisations about large corporations may overlook the better examples), but widespread evidence from around the world demonstrates that private property holders, including those with communally-held property rights, can and do protect public goods if the appropriate incentive structure is in place. In fact, rural communities own, or administrate under license, at least one quarter of forests in developing countries; and they invest $2.6 billion in conservation, exceeding state funding and all forms of international conservation expenditure combined.[8]

SECTION 2: THE RIGHTS HOLDER'S VIEWS OF INVESTMENT

2.1 Review of TFD's ILCF Dialogues

To date, the ILCF initiative has held a scoping dialogue in Brussels and field dialogues in Panama, Nepal and Macedonia. These brought together three groups of rights holders—Indigenous Peoples, community forestry groups, and forestland smallholders—who own or manage a significant part of the world's forest resources, along with other stakeholders of locally controlled forestry. In parallel to this process, The 'G3' network has been formed, representing the three rights holders' alliances: The International Alliance of Indigenous and Tribal Peoples of the Tropical Forests (IAITPTF), The Global Alliance of Community Forestry (GACF) and the International Family Forestry Alliance (IFFA). G3 aims

to promote locally controlled forestry for: Sustainable Forest Management, improved livelihoods and respect for forest and land rights.

The conclusions of the discussion groups can be grouped under five headings of: (i) Legal and institutional; (ii) Autonomy and Identity; (iii) Community capacity; (iv) Access to finance; and (v) Partnerships. This is not a comprehensive summary of all the topics discussed, but is a selective sample of issues that are relevant to this paper, in order to unpack certain key themes that can be discussed from the perspective of investors.

2.2 Legal and institutional

The G3 group defines 'locally controlled forestry' as follows:

'"Local" means near and in the forest—where you can "hear and see" what goes on in the forest; "control" means rights and responsibility, tenure and sustainability; and 'forestry' is more than timber production as many uses and services are interlinked. However, in many cases local people may not have formal legal rights and thus may not have quite as much control as they need to have any chance of attracting investors.' [9]

Therefore the definition of LCF, whilst pre-supposing rights and tenure, acknowledges the fact that in local legal definitions many local people do not yet have formal tenure, and their rights are based on entitlements to use certain resources. Their presence does not qualify as 'adverse possession,' which is the legal principal that assumes land to be owned by the exclusive occupier if certain conditions are met, regardless of other claims. The forest is usually treated as common land so their usage is not exclusive; and their activities are not sufficiently transformative. Ironically, land clearance for crops would in many places create a much stronger claim than sustainable forest management.

Even where local people do have formal rights, as in most northern hemisphere smallholder forests, they do not necessarily have much influence over how the land is managed. Unlike most other land types, the forest is regarded as either a local amenity, a national strategic asset or a global public good. For instance, community forests in Germany have clear legal title but they are heavily regulated, with sustainability and local amenity value as the objectives rather than economic value.[10] The Norwegian system gives the forest owner 'freedom with responsibility,' meaning that in the event of mismanagement the forest will be put under public management, with the costs of any work charged to the owner.[11]

There is consensus amongst LCF groups that *'recognizing and securing land tenure and user rights of forests are central to sustainable forest management.'* [12] This may reflect a pragmatic approach to lobbying both governments and international organisations, as tenure can be presented as a means to end. However, clear exercisable property rights should be an end in itself regardless of the claimed improvement in forest management, as they have been shown to advance development and alleviate poverty.

The actual type of tenure demanded will presumably depend upon the circumstances. Smallholders may require freehold or very long leases, but customary land held in common is often more complicated. Both governments and communities may be wary of breaking up common land into individual parcels that may then be sold or seized in foreclosure of a loan. As de Soto observed: *'Remember, it is*

not your own mind that gives you certain exclusive rights over a specific asset, but other minds thinking about your rights in the same way you do.' [13] He was thinking of individuals, but the issue is just as relevant to communities. Customary land rights need to have meaning outside their own boundaries and to be legible to outsiders so that rules of ownership and transactions are enforceable.

The Macedonia dialogue warned that fragmentation of forest ownership is a challenge to the optimization of production, the sustainability of resource management and maintenance of public benefits. The solution to this may lie in some from of collective agreement that respects private property rights while creating economies of scale and including sanctions to reduce the risks of free-riding. Of course it was arguments like these that led to the imposition of state control over forests in so many countries, and in former communist countries the notion of re-collectivizing may seem counter-intuitive. In Germany, community forests are often managed by the local government authority, as a democratically representative body it is best-placed to navigate the trade-offs required to balance public and private claims on the resource. This may work because it is a delegation of powers upwards (from the community to the local political institution), whereas in Indonesia, for instance, the decentralisation movement has pushed some autonomy over forests outwards to district governments; with little discernible improvement in management, and in many cases much more degradation.

The ideal sequence of institutional change may therefore be to start at the bottom and allow self-declared communities to define the boundaries of their forest and negotiate with proximate communities over rights and access (blending traditional norms with modern legibility), which may include gazetting smallholdings in some places, and then over time allow these institutions to merge with the local political authorities providing they have legitimacy and accountability.

2.3 Autonomy and identity

The Nepal dialogue noted that communities should be involved in defining the priorities for investments, as 'a local sense of ownership of the process and sharing of benefits increases security of control.' This is echoed by the G3 group: *'Locally controlled forestry leads to responsible, long term sustainable forest management, including protection of bio diversity, improved livelihoods, multiple forest products and services, local enterprises and benefits to society.'* [14]

Statistical evidence from 80 CFEs in 10 countries[15] shows that *'larger forest size and greater rule-making autonomy at the local level are associated with high carbon storage and livelihood benefits.'* From a pro-poor development perspective, community forestry does have clear attractions: it implies local participation, decentralisation and equity.[16] It also claims some logical rationale as those closest to the forest are more likely to have cultural and practical knowledge of the local landscape, and have a vested interest in the long- term conservation of its ecological services and income-generating features.

However, it is not clear how control will be exercised and to what extent it is applicable only to common land rather than smallholdings. Where do the boundaries of the 'community' start and finish? Who defines the insiders and outsiders? In most literature on the subject the various right-holders are lumped together as one group, For instance, the UK government's Eliasch Review [17] uses the terms 'indigenous communities,' 'local communities' and 'smallholders' interchangeably without attempting to

define these groups. Meanwhile, the report argues that 'migrants' are both a consequence and a driver of deforestation. It is not clear how long one needs to live near a forest before one is re-classified as a 'community' member rather than a mere 'migrant.'

There is a danger that investors embrace the terms used by the communities uncritically, developing a hierarchy of rights claimants.[18] Thus we have the 'deserving poor' such as hunter-gatherers in culturally interesting tribal groups who are deemed to be 'good' for forest resources. On the other hand there is the 'undeserving poor,' for example landless peasants, shifting cultivators and migrants, who are seen as destructive.

Furthermore, where autonomy is devolved to local right-holders, how is this managed in practice? The Community Forest User Group (CFUG) concept in Nepal is on a separate legal basis from the village leadership, which may be seen as a strength as it allowed the FUG to include actual users of the forest, who tend to be the poorest, rather than village elites, who may have a different agenda.[19]

However, village institutions could be said to have a symbolic role that may offer some stability in times of uncertainty. Radical changes to institutions, or the introduction of parallel institutions such as forest enterprises, may lead to instability and resistance.[20] On the other hand, it has been suggested that: *'Communities are less prone to "paralysis by committee" or infighting than is generally perceived.'* [21] The rights holders' groups may need to consider how they present evidence that communities are inherently inclined to consensus on social and environmental issues, as it may be the case that this consensus conceals power relations at work. No doubt the answer is complicated, because of the diversity of groups from around the world.

For instance, one major example where local right-holders have obtained tenure, attracted investment and engaged in timber enterprise is the Sealaska Corporation in Alaska, which is owned by 20,000 members of Native communities, from the Tlingit, Haida and Tsimshian tribes. The company admits that its logging practices have been destructive in the past, and local activists accuse it of clear-cutting 80% of its lands.[22] Furthermore, as the company exports roundwood direct to Asia, it has failed to build up a processing industry that may stimulate local economic development. This is an isolated example, but there is always a danger that greater local autonomy leads to rent-seeking rather then long-term development and a fair division of the spoils.

Regardless of how the groups define their approach to autonomy and decision-making, they will need to prepare themselves for change, as exposure to market relations may force them to reconsider some of their existing institutional arrangements. If the theories regarding the links between autonomy and improved livelihoods are correct, then the positive changes should outweigh the negative, but in some fragile communities any change may be traumatic.

This requires a realistic sense of the unintended and unknowable consequences of progress. As a village elder in the Papua highlands put it: *'What happens if we get rich? Will everyone stop chewing betel nut and start smoking? Will nearby communities get jealous and sabotage our efforts? Will we afford a better education for our kids just so they are compelled to seek opportunities in the city and*

lose their cultural roots? We want development and prosperity, but we should also keep our eyes open and be careful what we wish for…' [23]

This is relevant to investors as there may in some cases be reluctance to be part of an intervention that induces rapid social change. However this in turn may lead investors to adopt a patronising stance to rights holders, especially Indigenous Peoples, while failing to appreciate their rights to determine their own development model.

2.4 Community capacity

The Nepal dialogue acknowledges that more effective management of forest resources calls for upgrading skills to plan, design, implement, and manage the forest resources. Eventually, this will lead to new economic activities and thus over time less dependency on external technical assistance. As the Panama dialogue notes, this may be achieved partly through addressing isolation. There are currently insufficient opportunities for the involvement of communities in national and international policies, but as rights-holders form into a more visible business sector they are likely to become active players in policy-making, markets, technical forums and negotiations.

Isolation may also be addressed through clustering and networking on a national and international level, with knowledge transfer and training programs between rights holders groups as well as sharing best practice.

The Nepal dialogue pointed out that skills development in the field of leadership is lacking and that involving both women and youth in community affairs would ensure long-term continuity. As well as leadership, there may also need to be acceptance that some individuals are more entrepreneurial than others, and that in some cases what from the outside appears to be 'elite capture' may actually be part of the social context and not necessarily a negative event, particularly if it leads to better performance.

2.5 Access to finance

The Brussels dialogue recommended that the expected increase of interest in forestry as a key factor in climate change should be matched with clear visions, missions and objectives from LCF communities to attract funding for sustainable forestry and rural livelihoods. However, it also noted that *'LCF is perceived to be incompatible with commercial forestry.'* The Macedonia group followed this up by suggesting that there is a need for the financial sector to understand needs of smallholders and forestry-based businesses, and that 'special skills are required among financing institutions.'

However, the financial sector could argue that the obligation rests with LCF to present their case in terms that relate to real business models. There is a danger that the more rights holders plead themselves to be a special case that requires new insights and specialist skills, the less likely it is that investors will engage with the sector, seeing only uncertain returns and high transaction costs. Investors already have the knowledge and skills to understand businesses, and may also have particular interest in small companies in the forestry sector, but their analytical approach will be broadly similar regardless of the sector or size of business.

There may be some concern among investors that certain types of community organisation are incompatible with commercial realities, but this may be because social or environmental goals have been advanced in front of financial ones. LCF groups should not always assume, however, that an investor who insists on business goals is necessarily less desirable than more philanthropic investors who may be less concerned with high rates of return. Some organisations (such as conservation NGOs) may support community forestry precisely because of its perceived incompatibility with 'commercial forestry' and thus deliberately perpetuate the circumstances by which such commercial activity is impossible, inhibiting future development.

Furthermore, where business models are imposed on communities by philanthropic sources they are often formed within a very restrictive definition of SFM, one that permits no logging whatsoever and requires that local livelihoods are subordinate to environmental goals. In many cases, the community may be better off with a plain speaking profit-oriented investor who barely understands their circumstances rather than a seemingly munificent donor whose goals are more opaque.

Certain investors will be interested in any proposition that is commercial, even if it is slightly tangential to traditional 'commercial forestry' (understood to mean logging). The G3 group argues that investors need to consider the forest as whole, as a holistic system that is more then just trees. It delivers multiple benefits as an integrated system of trees, animals, products and services, economic viability, cultural values and people.[24] However an investor will be seeking the actual investible entity in this convoluted system,[25] which is why they tend to focus on just one aspect that can be monetised or securitised, e.g., timber, water rights or biodiversity. Understandably, LCF groups are concerned that the holistic approach of SFM, including its social, environmental and economic objectives, should not be compromised *'by a narrow focus on a single commodity or service of forests, such as carbon sequestration.'* [26]

Investors may not yet share and understand this broad definition of SFM, nor grasp the importance of the reinforcing loop between improved grassroots economic and social development and improved asset quality over time. Once again, right holders need to present evidence and models that illustrate how this holistic system will work on a commercial level.

2.6 Partnerships

The Brussels dialogue concluded that ensuring the profitability of locally controlled forestry presents significant challenges but there is space for new business models and new partnerships with other stakeholders. From the point of view of investors this is a positive move, as it acknowledges the importance of flexibility to new commercial approaches.

The Brussels dialogue also warned that *'the role of intermediaries can be positive but is often unclear and can reduce the sense of ownership and empowerment felt by communities.'* This may be caused by the complexity of donors procedures and policies, meaning that communities do not have the capacity to receive direct financial flows, which instead are channelled via intermediaries, with dangers of co-dependency. A recent ICRAF survey revealed that *'some community forests claim to be held "hostage" by local NGOs in a bitter-sweet relationship of mutual need.'* [27] One could speculate that the

community is fulfilling social goals at the expense of long-term business sustainability to either comply with the wishes of the NGO, or to perpetuate the symbiosis.

Indeed, the Panama dialogue called for 'performance indicators which focus not only on economic efficiency but also in results to achieve indigenous rights...and other indicators identified as significant by the community,' yet this seems to presuppose that CFEs can aim for and achieve a broad spectrum of goals simultaneously. Experience seems to show that some of these goals may be conflicting, or should more properly be tackled in sequence rather than all at once.

One should bear in mind that investors may also need to work through intermediaries to seek and engage CFEs. However, investments should usually be made directly into a viable enterprise rather than via an NGO. In some cases this may mean that intermediate enterprises, or brokers, exist at various points in the value chain. Financing could be directed to the better-capitalised downstream companies, whom then form partnership contracts and joint ventures with rights-holders up stream. However the relationship between all these companies must be equitable and commercial in nature.

The Brussels dialogue called for *'new marketing models that shift from competitive to cooperative and new partnership models based on multi-stakeholder involvement.'* There is a sense that there are *'two basic models to partnerships: the shareholder model and stakeholder model,'*[28] in which there is a trade-off between efficiency and equity. However, competitive/cooperative or shareholder/stakeholder are not always binary choices. It is possible to be both competitive and cooperative, and of course SMEs need to be competitive to innovate and produce profits (and thus returns to investors). Investors may prefer to enter into partnerships based on shareholding so as to be better able to distribute incentives and reward good performance amongst certain key stakeholders. Other stakeholders may participate in co-benefits and externalities, but not have a direct financial stake in the venture.

SECTION 3: THE INVESTOR'S VIEWPOINT

For the purposes of this paper, investors can be divided into three 'ideal types' of Value Investors, Social Investors and Conservation Investors, defined by goals, pre-conceptions and expected return on investment. As with all such exercises this involves both simplification and exaggeration of certain characteristics and tends to overlook those aspects that overlap the artificial boundaries, in order to form a framework for analysis.

Broadly speaking, the different types are defined as follows:

Value Investors are seeking a real return on capital, that is to say they do not expect to lose the real value of their investment over the medium to long term. Some may be more aggressive in pursuing this objective than others, for instance requiring a superior rate of return, while others will be satisfied with a 'better than cash' return. Value investors tend to deal with the world as it is, and are sanguine about the ability of open markets to deliver efficiency (if not necessarily equity).

Social Investors are investing as a means to an end, pursuing goals that are separate from the requirement to earn a return on their money. In many cases they may expect no real return, or accept risks

TABLE 2: INVESTOR TYPES

Ideal Type	Model	Example
Value investors	Debt, Bonds and Securities	Banks (domestic and international) Pension funds Sovereign Wealth Funds
	Equity in commercial enterprises	Foundations and endowment funds Equity funds (retail or private) Socially Responsible Investors (SRI) Venture Capital For Sustainability (VC4S) Sovereign Wealth Funds High net worth individuals (HNWI) Local Entrepreneurs Returning émigrés
	Co-investment	Multilateral Investment Institutions (e.g., IFC, Global Environment Facility)
	Carbon REDD+	Multilateral Financial Institutions (e.g. World Bank Forest Carbon Partnership Facility—FCPF) Carbon offset funds and brokers Socially Responsible Investors (SRI) High net worth individuals (HNWI) Hedge funds
	Direct ownership of forests	Real Estate Investment Trusts (REITs) Timber Investment Management Organizations (TIMOs) Carbon offset funds and brokers High net worth individuals (HNWI)
	Insurance and derivatives	Hedge funds Specialist insurers (e.g., GuarantCo, ForestRe) Multilateral Financial Institutions (e.g., MIGA)
Social investors	Soft loans, microcredit	NGOs, bilateral and multilateral Donors Philanthropists
	Grants	NGOs, bilateral and multilateral Donors Philanthropists
	Equity in commercial enterprises	Foundations and endowment funds Socially Responsible Investors (SRI) High net worth individuals (HNWI) NGOs, bilateral and multilateral Donors
	Carbon REDD+	Multilateral Financial Institutions (e.g., World Bank Forest Carbon Partnership Facility—FCPF) Socially Responsible Investors (SRI) High net worth individuals (HNWI)
Conservation investors	Grants	Conservation NGOs, bilateral and multilateral donors
	Equity in commercial enterprises	Foundations and endowment funds Socially Responsible Investors (SRI) Philanthropists NGOs, bilateral and multilateral Donors
	Conservation Trust Funds	Foundations and endowment funds
	Carbon REDD+	Socially Responsible Investors (SRI) Philanthropists NGOs, bilateral and multilateral Donors

that are not usually justified by the rates of return on offer. Typically they are promoting development in some way, or acting as a pioneer investor in the hope of attracting mainstream capital. Social investors are attempting to change the circumstances of poor people through their investments, and recognise that markets often fail to deliver outcomes that are either efficient or equitable.

Conservation Investors are using their capital to protect or restore a specific landscape, habitat or species. As with social investors they are less interested in earning a real return on their capital. They may view environmental degradation as an example of the market's failure to set appropriate prices on ecosystem services, and thus they use their capital to correct this distortion. However in some sectors they may feel there is no place for the market in the natural world.

Examples of the ideal types, and the investment models they are likely to deploy, are laid out in Table 2.

Each investor type is analysed below in terms of their needs and pre-conditions for investing in locally controlled forestry; challenges and obstacles likely to be faced by them; and opportunities for progress in future. There are obviously common themes that affect all investors (e.g., political risks), but in this analysis the issues have been grouped according to where they are most relevant.

3.1 Value Investors

Needs / pre-conditions

- **Attractive returns on capital**

  Investment, as mentioned in the previous section, is defined by the ILCF project as **the active allocation of resources to enhance forestry assets not only in the present but also for future benefits,** however value investors may not always agree with this definition if they do not participate in all the future benefits of the enhanced asset. For investors, the future benefits are cash-flow, but they may require some contemporary (or near contemporary) benefits. Enhancing forest assets for their own sake may be interesting for the landowner, but for the investor there needs to be a value proposition beyond the mere continued existence of trees.

  Investors seek 'attractive' risk-adjusted returns. Attractiveness is subjective, but all investment carries an opportunity cost that equals the income that could be obtained if the capital were invested in alternative assets, e.g. equities, bonds or property. Therefore a 'positive' return is not enough, it must also be superior to the other options. As this is hard to predict, the investor assesses both risk (adverse events that will reduce returns) and certainty (the probability of such risks occurring). For instance, investors indicate[29] that they require an internal rate of return (IRR) of 12–20% for tropical forestry investments, or a premium of at least 7% over equity returns. The emerging markets, placed in ascending order of risk, are: Latin America, South East Asia, Africa.

  Certain types of investors, such as pulp and paper companies, may be investing in smallholder forestry as part of a supply chain strategy, with the goal of securing raw material supply through contracts with outgrowers. The return on capital therefore accrues to the capital-intensive

processing unit rather than the plantation (through capacity utilization), and in some cases the company benefits from 'capturing' the supply chain in order to achieve lower prices for fibre.

Stability

The attraction of forestry is that it is uncorrelated to other assets. Most other investments (e.g. equities, bonds, property) are in some way inter-connected, with movements in one asset causing movements in another. This exposes the investor to systemic risk (as has been seen in the recent credit crisis). Forestry, on the other hand, is connected to biological growth and long-term movements in certain commodity prices (e.g., timber, pulp, veneers). This makes forestry attractive in long-term portfolios as it provides stability over time rather than brief periods of unusually high returns. Some studies have shown that the sector has not only provided less volatility, but overall has given better returns.[30]

Thus the investment proposition for forestry (particularly US forestry) is slightly less exciting returns but with the advantage of lower volatility and thus predictable returns over very long time periods. In the tropical forest context, the risk profile changes, and volatility is likely to increase. Tropical forestry thus moves from being the solid bedrock of the portfolio, and becomes the high risk/high return play for a necessarily smaller part of the portfolio.

This may help explain the preference for plantations over natural forest, driven by better management, scale, clearer markets etc. As a UK-based broker and consultant to forestry sector observed: *'Investors shouldn't be investing in forestry to get a higher return. The reason you should be investing in forestry is following the capital asset pricing model, the return is less volatile than in other asset classes.'*[31]

Liquidity

Regardless of whether the investment is short or long term, investors require an exit route and known time frame and some may seek the possibility of early liquidation. Even with young tree stands the future harvest may be tradable between investors, but for creditors (e.g. banks) the secured asset may need to be tangible, seizable and marketable in the event of a default. In many circumstances, standing trees are only satisfactory bank collateral if a permit exists to fell them immediately, or if a secondary market exists for the future income flow. For investments in processing units, liquidity will depend upon the strength of the balance sheet, which may defer an investor's exit beyond the original time frame predicted by the business plan. There is most unlikely to be a secondary market in the shares of unlisted companies.

Investible entity

The investment must be linked to an asset in some way that will deliver the future cashflow (e.g. coupons or dividends). Usually, the only way to participate in the asset is to own shares or debt in the enterprise (or portfolio of enterprises). This requires a recognisable legal entity.

Viable Business Proposition

An implementable plan based on an understanding of the customer needs, value proposition and value chain, with proof of expertise in the local market

De-risking measures

Anything that can help make risks more measurable, and reduce uncertainty, would not only increase the investment flow to tropical forestry (by moving it from the periphery of the portfolio), but would also attract investors that are satisfied by slightly lower rates of return, thus reducing the costs of capital. These measures may be institutional or financial. The latter could be satisfied through forms of credit enhancement or insurance that cover default on the part of the borrower, or co-investment in equity or debt on a 'first-loss' basis. Institutional conditions can be made more suitable for investment through improving the enabling environment for business, for instance as measured by the World Bank 'Doing Business' Review,[32] including:

- Clear tenure and usage rights for defined periods
- Enforceable contracts and terms of payment
- Foreign Direct Investment rules will need to allow foreign investors to own equity stakes in local companies, and that do not place forestry on the negative list
- Level playing field (e.g. forest governance excludes illegal logging)
- Many players, open markets and competition
- Fiscal rules that encourage investment in SFM

Triple bottom line

The return on capital is an absolute requirement for value investors, but they may also look for co-benefits that satisfy the 'triple bottom line' of economic, ecological and social outcomes.[33]

'Social license' to operate

This implies the willing consent of local people, (through an FPIC process) which goes beyond local legal requirements, which may be quite weak. This is partly to preserve the investor's reputation, but there may also be a strategic interest in good local relations, particularly for local joint ventures that form partnerships with the community.

Challenges / obstacles faced when investing in LCF

Missing middle

For most investors, the requirement for investible entities and a legal hold over income-producing assets, along with the desire for a reduced risk profile, tends to direct investment towards plantation investment, or into the larger processing units (that have more visible legal collateral, and where due diligence processes are easier). Carbon investors may be attracted to natural forests, but not necessarily in partnership with the local rights-holders.

Between these two ends of the value chain are found most of the LCF businesses. Though they may have certain forms of forest tenure, this is usually based on usage rights or licenses, and cannot be used as collateral. They may not choose to use their own small-holdings as collateral as losing their only asset would expose them to unacceptable vulnerability. The processing businesses that CFEs may wish to engage in require up-front capital investment and working capital, neither of which will be forthcoming from a bank, and hold no interest for the 'carbon'

investor. Also, the banking industry may be underdeveloped in some countries, with no presence outside the cities and lacking the skills and capacity to evaluate LCF enterprises or price the loan appropriately. As these businesses will not achieve scale for a while, they require investment that is both patient and willing to accept some risk. In short, this 'missing middle' of value chain may need some form of specialist investment capital.

Tenure and Rights

The notion of rights has multiple meanings. As one investor put it: *'...what do you mean by "rights holders"—do you mean the smallholders ?—or the project manager?—or both?—or who else?'* [34] Although this topic is usually discussed in relation to the rights of local people who live in and around the forest, an investor may first be concerned with understanding the rights of investors in the context of competing claims on assets and cashflows.

Furthermore, there are two types of rights: those related to transactions and those defining ownership. If a transaction is made in good faith, yet later needs to be unravelled to satisfy a stronger pre-existing claim to the property, a trade-off is made between the right of ownership against the security of transactions. A jurisdiction may decide to protect the rights of innocent third parties in restitution claims, and thus demonstrate that transactions are backed by the rule of law. Alternatively, they may allow the claim over property, thus conveying the principle that private property rights are paramount, as the cornerstone of a sound economy. Either decision is sound, but involves determining a hierarchy of rights. In developing countries this paradox may lead to unpredictable decisions that are uncomfortable for both investors and local rights holders.

This is the reason why lack of clarity about land ownership is the prime concern of investors, according to the Clinton/McKinsey survey.[35] Investors with experience in timberlands may expect a form of unqualified land ownership, such as 'fee-simple' or freehold. As this is less common in emerging markets, the Global Environment Fund (GEF)[36] suggests that *'investors must be comfortable negotiating long-term leases or concessions.'* However, the danger with this approach is that the ownership of so much forest around the world (especially in the tropics) is contested.

Where investors look beyond the tenure on offer from the local government, they may find a tangled nest of issues awaits them, with competing claims to both the land and the standing assets from local rights-holders. Investors may be neither willing nor equipped to deal with these issues. For instance, the PWC Forest Finance Toolkit[37] lists Indigenous People as a 'site risk': *'Does the company buy from or operate in a high risk location including: Areas including indigenous peoples with insecure land tenure or unresolved land rights.'*

Even in the event that local rights-holders do have recognisable legal rights, such as smallholders, it may not be clear how these 'rights' can be monetized or securitized if they are not assignable, and it is most unlikely that Indigenous People can officially grant natural forest leases to investors (though unofficially such deals happen all the time).

REDD may be changing the nature of this debate, as carbon investors realise the apparent owner of the forest (usually the state) is not in practical terms the party responsible for its long-term quality. This is where a holistic sense of the forest is required to appreciate the full range of social, economic and environmental aspects that will interact to support or foil attempts to preserve a particular dimension of asset quality (e.g. carbon density) over very long time periods.

Relations with the rights-holders

Forming a business relationship with local rights-holders presents a number of challenges for investors. They first need to establish the composition of the community, and prepare to negotiate with parties whose objectives and norms may be somewhat opaque when compared to dealing with the private sector or governments. A number of issues arise:

- How to conduct an FPIC process and overcome disagreements
- Legacy of past grievances—the newly arrived responsible investor may find themselves paying the price of the community's ill treatment at the hands of a previous investor.
- Which local institutions are representative, and which one is able to enter into a business deal? (who can we do business with?)
- The person most willing and able to do business, may not necessarily be representative, and thus benefits may get captured, causing problems later on.
- The local government may be representative and decentralised, but can it act as delegate for the people?
- Who has right to be consulted, and who has right of veto? Does the community encompass migrants as well as Indigenous People?
- To what extent do community norms about representation clash with investor's norms (or universal norms), e.g., excluding women, disabled people or an underclass?[38]

The complexities of negotiating with local rights-holders, and the absence of a community-owned viable business entity in which to invest, leads most investors to form a deal with the state through a concession or lease, and the better companies then consign the 'community issues' to the Corporate Social Responsibility (CSR) department. Profits from the project, rather than distributed to the local rights-holders in cash as if they were bona fide co-investors, are instead invested in local amenities, such as schools and health clinics.

Partnerships between companies and communities, such as outgrowers schemes set up by pulp manufacturers, may experience tense relationships depending upon how the original deal was formulated (the state can often play a negative role in such negotiations). In this context, CSR programmes are often presented as part of the compensation model, which reduces transparency and may even be counter-productive.[39]

More enlightened investors appreciate that local economic development must be part of the mix, for instance GEF states that: *'...smart managers often seek to develop opportunities for community businesses that take advantage of the forest resource.'*[40] However these are subsidiary to the main investment in the forest, and seem to perpetuate the notion that local people

(particularly Indigenous Peoples) are best suited to low input/low return activities, producing inferior goods, such as fibre baskets and fuelwood, that will be displaced over time.[41]

Community Capacity

Investors, even in the most intrepid field of venture capital, assume that the organisational and individual capacity of the enterprise is already at the required level to execute the business plan successfully. The Investor may find ways to enhance this capacity, or allow for training costs in the plan. However in ILCF there will usually be significant requirements for capacity building, which the investor may not allow for or consider part of its responsibility. This is especially the case with banks that are wary of lending to organisations that may not possess relevant financial management skills. Even if communities have made an effort to enhance their own capacity they may be inhibited by the negative perceptions of them held by financial institutions.

For instance, there may be the perception that Indigenous Peoples, forest communities and small-scale, family forest owners do not possess an entrepreneurial culture, or are resistant to making the full transition to a market economy. In some cases this may be true, but it may also be the case that investors misinterpret the practice of holding assets in common as a general rejection of capitalism. There are many instances where commons and capitalism co-exist very successfully; indeed one could argue that the 'joint stock company' (the institutional cornerstone of capitalism) is an example of pooled ownership of assets and liabilities, with mechanisms for deferring the distribution of income to ensure that all share the burden during hard times.

Viability of enterprise

The main problem with investing in forest enterprises at the locally controlled level is that they are usually small scale, difficult to access and hard to evaluate. This makes the due diligence process expensive and time consuming, raising the transaction costs beyond levels that investors would generally find acceptable. To overcome the problem of scale, investors need to aggregate several similar projects together, but there are usually many practical challenges to researching and contacting the investment candidates, and once they are activated there are similar problems with auditing and transparency when affairs are conducted over distance, usually through intermediaries. For this reason the Clinton survey puts the median investment size at $20m[42]—way beyond most ILCF scenarios.

Investors have also indicated that LCF enterprises may lack securable assets (personal assets, buildings, physical equipment etc.) that can either act as collateral or form part of the investment equity.[43] This in turn reduces the opportunity for debt financing, so the deal has to be built on equity only, reducing the rate of return.[44]

Furthermore, there is a need for a total investment package that takes into account the fact that LCF enterprises very rarely have access to formal banking services such as sales ledger financing, leasing and insurance. This means SMEs need a larger cash float to cover the costs of larger orders and avoid 'over trading,'[45] drawdown capital in the event of uninsured risks and capital expenditure loans to cover the cost of equipment that cannot be leased.

TABLE 3: COMMON INVESTMENT RISKS

Risk	
Political and Economic	Capricious governance Export bans, trade embargoes, Import controls leads to shortage of imported inputs (spare parts, etc.) Fiscal crisis, hyperinflation Currency risk—non convertibility, capital controls, sudden revaluations War or civil unrest
Physical	Fire, pest, wind, drought, seismic event Encroachment, theft, malicious damage
Institutional	Weak rule of law Poor regulatory/fiscal regime Corruption Blurring the line between SOEs and State, (e.g., Perhutani in Indonesia, or State Forest Enterprise in Macedonia, where it is 'regulator, producer and promoter' and even sets prices for wood products). Involvement of army and police in value chain Negative consequences from disruption of current market relations, e.g., middlemen, military/police business interests, etc. Health and safety, child labour
Market	Fragmented value chain Monopsony practices by big mills Local monopolies distort markets, heavy government or NGO involvement in a sector can stifle competition and innovation. Low-cost competition (illegal/unsustainable) Open access regime undermines plantation business model Uncertainties over carbon markets post-Copenhagen

In many instances, for instance plantations or reforestation schemes, investors are co-investing with local rights-holders. However, outside investors can factor the delayed cashflow into their business model to calculate the total return over time, whereas local people need cash early on in the scheme as they may not have other sources of income, and the plantation may displace cash crops. With a share structure, you cannot usually distribute profits selectively—all parties must receive any dividend that is declared. The challenge is to design a business model that resolves this challenge equitably.

Distributing costs and benefits

It is common in recent projects to build the revenue model around the likelihood of carbon income. However, this assumes all forest carbon in the project area is available as an unencumbered asset to the investor. This overlooks the likelihood that it may be deemed a state asset, with its sale handled by a regional or national body. In many places it is not clear if carbon revenue (e.g., REDD) will be treated as 'rent' to the forest owner (often the state, with a share allocated to local rights-holders), or a payment for services rendered in preserving the carbon. If it is merely rent, then it will be difficult to link specific activities to the carbon payment.

Capturing the carbon income may require some form of performance agreement, which raises the issue of attributing the carbon revenue to the group that has carried the opportunity cost. These complications may make it harder for the investor to evaluate LCF proposals,

leading them to favour larger carbon-only projects that may be less focused on grass-roots economic opportunities.

Risks

The risk profile of LCF largely reflects the country context, though there also some sector specific risks. These are laid out in Table 3.

Opportunities

Improve the business proposition

Investors are already convinced by role of SMEs in the economy at large, and pragmatic about the risks of investing in that sector. Scale becomes less of a problem if the obstacles to aggregating projects can be overcome, and investors can use portfolio approaches to mitigate risks. The investment proposition is that value can be released through enabling communities to obtain command over their forest resources, manage themselves as a viable enterprise and establish linkages further down the value chain.

- There may be opportunities to make strategic and complementary investments across the value chain to overcome bottlenecks and fill gaps. Broader market presence means the ability to form vertical linkages (e.g., access to specialist markets etc.).
- Capacity building and training costs can be factored into initial investment, without reducing the IRR significantly, perhaps by less than 1%.[46] Also, agencies that provide organisational development (e.g., Business Development Service Providers) may themselves be investment opportunities.
- Certain investors can apply their experience in venture capital to the LCF sector, enabling innovative or fragile businesses to be incubated until they reach viability and scale.
- More equitable and productive Company / Community partnerships can have strategic value to the investor that goes beyond the usual CSR goals. This will require codes of practice and performance agreements to apportion responsibilities and benefits fairly between all parties.

Many different types of potential investors

There is now a wide potential universe of investors: equity funds, Timber Investment Management Organisations (TIMO), Real Estate Investment Trusts (REIT), carbon funds, pension funds, Sovereign Wealth Funds etc., many of whom are becoming adept at reconciling sustainable investment goals with attractive returns. Investors are beginning to understand the causal loop between local livelihoods and long-term forest asset quality, which is important for REDD type investments.

At the time of writing, the global economic crisis has led to a fundamental re-assessment of the wisdom of holding certain types of fixed income investments correlated to other financial assets. The recent increase in government borrowing has been financed by short-term securities (5–10 years), making no impact in the shortage of long-dated securities required by pension funds.[47] There may therefore be interest in longer term (25 years plus) securities that can be matched to specific long term liabilities.

Innovative financing models

The openness and fluidity of international capital markets can be a crucible for innovation, which may lead to the emergence of models that resolve some of the issues facing sustainable forest management. For instance, Real Estate Investment Trusts can solve the principal/agent and 'negligent landlord' problem (whereby the state grants concessions but does not have the capacity or inclination to oversee them properly or insist on restoration bonds to ensure long term forest quality).

As IFFA puts it: *'SFM needs a long-term commitment, and such a commitment needs tenure rights.'* Investors see this as: a long term investment needs long term asset quality, which in turn requires all stakeholders to have a stake in that quality, which requires a separation between the investor, regulator and manager. This could lead to improved concession models in which the local rights-holders agree to encapsulate their rights in an existing legal instrument (such as a timber production concession), without forgoing their pre-existing claim.

The concession is then held by the REIT, which in turn appoints the community as manager, probably in partnership with an experienced timberland manager who co-invests in the project. The REIT has a long-term financial interest in the asset quality, whilst the community has its existing interest and the co-manager needs to apply professional SFM methods to avoid cessation of the contract. All parties can agree terms on extraction rates (probably based on an existing certification model). The state regulator becomes effectively redundant. Such a model would be more likely to form part of a sub-national or project level REDD or CDM project.

Legal and Institutional

— Investors and rights holders can agree to notarise their legal agreements in a different jurisdiction to avoid capricious local courts. For instance, some projects in Papua Province intend to specify that legal redress be sought in Singaporean courts rather than in Indonesia.

— Code of practice for partnerships should be drawn up that also specify an ombudsman or commissioner for arbitration.

Research & development

— Information technology is improving communications to even very remote areas, which will contribute to reducing the transaction costs involved in finding and monitoring LCF enterprises.

— Higher returns can come from over-harvesting, but this carries risks for investors, depletes asset quality and may cross-over into other investment returns (e.g. carbon). So investing in R&D to increase efficiency in SFM context is a more attractive means to increase yields. Also, investment in proximate activities, such as increasing yields in oil palm plantations (best practice methods, etc.) can boost livelihoods and reduce pressure on land for conversion whilst also increasing the land value of the plantation.

De-risking measures

To some extent political and economic risks in emerging economies may be over-estimated or misunderstood by investors. There are a number of measures that multi-lateral financial institutions and 'soft' investors can take to improve the risk profile, for instance:

'HARD' INVESTMENT		
Risk	**Mitigation**	**Example**
Political	Public sector insurance	Multilateral Investment Guarantee Agency (MIGA)
Default on loans	Credit enhancement	GuarantCo, IFC
Exchange rates	Hedging/derivatives	Investment banks
Business failure	'First loss' co-investment	IFC, Cordaid
'SOFT' INVESTMENT		
Risk	**Mitigation**	**Example**
Governance	Institutional strengthening	Multilateral and bilateral donors, FIP
Poor forestry management	SFM and certification	Multilateral and bilateral donors, FIP

— Genuine partnerships with local rights-holder may also help to overcome the negative perceptions of tropical forestry. Partnerships with rights-holders are 'proof' of due diligence and the value of the triple bottom line.

— Natural forestry is *'harder to understand due to its diversity and is more difficult to model financially. It thus gets 'mis-priced in the marketplace.'*[48] Tropical forestry is even more difficult to interpret, and therefore the opportunities are arguably even higher. The opportunity is for rights-holders to be the holders of the information, knowledge and data about the forest that can be used to build an accurate financial model. Rights-holder's organisations could take the lead in developing and testing these models.

3.2 Social Investors

Needs / pre-conditions

Advance Development

By definition, social investors see ILCF as a means to an end, and will be interested in meeting social goals as well as business goals. They may require that the business or project accommodate certain cherished cross-cutting themes, such as gender.

Achieve institutional change

The investor may see the project as an opportunity to clarify rights in the local institutional and social context, and solidify them in the national legal system, perhaps as part of a process of governance reform.

Address Market failure

In many cases the reason why social investors feel motivated to invest in LCF is because they recognise problems in the value chain that constrain local communities from managing enterprises successfully. They may therefore set up parallel markets and differentiation (e.g., Fairtrade), or compress the value chain to capture more rent upstream, for instance through setting up clearing houses for aggregation and marketing of community products. They may also see their role as shielding communities from the risks associated with private enterprise.

Planning-led project design

In many cases, social investors are acting within the constraints imposed by the fact that their funds are provided by public institutions and multilateral bodies. Their investments are thus made within the context of the bureaucratic planning cycles, and may encompass proximate projects such as Microfinance.

Challenges/obstacles faced

Competing goals

There may be instances where NGOs and rights-holders are keen on using the local enterprise to achieve multiple goals, many of which are not directly pertinent to the business (e.g., social goals, 'achieve indigenous rights,' community cohesiveness, traditional knowledge capture, etc.). Such social goals may compete with business goals, to the detriment of both, or they may conflict with local norms (e.g., gender equality), or they may involve picking sides between communities (e.g., indigenous v. settlers).

There may also be reluctance to encourage community enterprises to engage in activities that could destabilise existing community relations. This reflects risk aversion on the part of community advocates, who may overstate the real risk of failure and misunderstand the benefits of setbacks that induce learning and innovation. They may also insist on collective decision making, preferring 'democratic community forest enterprises',[49] yet arguably in the real world very few successful enterprises are run along such lines.[50]

Funding led by trends

The investment or grant support may be tied to donor's time horizons and current project concerns, rather than based on actual funding needs of the enterprise. For instance, many institutions are currently concerned about climate change, with budgets for tackling forest carbon issues. This skews projects towards sequestration or avoided deforestation models as a form of what GACF calls *'climate change colonization.'* [51] This may mean that funds are pulled away from investment in productive activities, such as processing, and attracted to projects that merely generate rent.

Lack of business focus

A successful business aims to achieve internal goals by satisfying external customers, which may be disconcerting for NGOs that are set up to achieve external goals.[52] This often leads to a misunderstanding of customer needs in terms of quality control, timeliness of delivery and price

performance. A failure to make a profit tends to be conceptualised as being attributable to some exogenous factor, such as market failure or structural constraint (which may indeed be troublesome), yet often it may be due more to poor interpretation of customer needs.

Furthermore, in the pursuit of social goals, it is quite common for LCF enterprises to be expected to spend profits on goods and services that contribute to local development. Indeed, local social benefit is often touted as one of the attractions of promoting the sector. However, the distribution of profits may be based on poor financial reports that understate or misunderstand future liabilities. The business then risks running down its own capital base (as it is often the depreciation fund that is seen to be 'spare' cash and is first to be depleted), as is the case with AFHAN in Cameroon (see case study in Appendix). The business becomes more emaciated and may make only token payments to capital, thus inhibiting local investment, as only wealthy foreign institutions or philanthropists can afford to subsidise the lower returns. A different form of dependency emerges.

It may be better to re-frame 'social premiums' and payments to village development funds as 'dividends.' They should thus be subject to a sensible dividends policy. If there is no profit there should be no dividend, where 'profit' is net of all charges, interest, taxes and depreciation, and where sufficient capital is kept in the business to cover potential liabilities such as uninsured risks.

Misunderstanding the value chain

Donors and NGOs, often dislike the role of middlemen in markets, believing they extract too much rent by exploiting their superior access to market intelligence, networks and capital. However this can be based on a misinterpretation of the value chain. In order to overcome what is seen as market failure and close the gap in the chain, some organisations propose models that exist in a kind of parallel universe. For instance setting up 'clearing houses' for purchasing and marketing community products (especially NTFPs). These may seem a good idea in principle, but they can suppress the price signals that are needed to stimulate product development and quality control. Also, as these organisations may have inexperience in finding markets for the goods they buy (and are often supply-led rather than demand-led), they become the 'buyer of last resort,' accumulating product that they cannot sell at appropriate prices.

It may be better to overcome the suspicion of the 'middleman' and invest in a separate product aggregation and distribution business, whilst encouraging LCF businesses to focus on portions of the value chain over which they can currently exert some control and add value efficiently. A good example of this is GreenWood in Honduras (see case study in Appendix), which acts as the broker between a highly discerning customer and the community enterprises, matching production to confirmed orders (paid for in advance) rather than buying all production on a speculative basis. In this case the 'middleman' role works because all parties insist on transparency and fair dealing, and an understanding of each party's strengths and weaknesses. They explain that that they *'…are trying to redefine the traditional broker's role into a much broader combination of functions. Quality control, on-time delivery and the financial transactions are a few of the basic elements, but some of the other functions are equally important. "Broker" is a dirty word in Latin America, where it is often used interchangeably with "coyote" because of the traditional*

exploitative relationship between brokers and producers. GreenWood is attempting to create a new model, which I like to call "coyote verde."' [53]

- **Displacing private and public investment**

  Social investors may be less interested in taking equity stakes in LCF enterprises, or taking a charge over assets to cover credit positions. They can afford to be satisfied with lower returns and less recoverability, as the investment is usually subsidised by donor funds or public money. This may displace conventional private investment that may otherwise have contributed to the development of a viable financial services sector. It may also create moral hazard, as community enterprises that do not experience any downside to poor performance may have no incentive for sharpening their management and becoming more competitive.

  There is also an argument to be made that investing with social goals in mind may, ironically, undermine the emergence of democratic institutions. The local social investment (books for schools, boreholes, etc.) displaces government expenditure. It may be better for enterprises to formalise their relationship with local government, insist on paying taxes and thus obtain the status and voice of active citizens (rather than passive welfare recipients). NGOs may think that it is 'empowering' for people to build their own school, but every unit of labour has an opportunity cost that could be better employed elsewhere. It may be in the community's economic interest to specialise in building viable forest enterprises, increase productivity and profits, with the goal of paying taxes and engaging with the political process of determining spending priorities and trade-offs in the public sphere.

Opportunities

- Social investors are prepared to work in remote places and with an existing network of local agencies that often have the scope and reach to overcome the political and economic isolation that LCF enterprises experience.
- Capacity building should not focus only on technical skills, it must also encompass the organisational strengthening that can help communities develop resilience. This is more effective than providing safety nets that shield the enterprises from failure, which run the risk of creating moral hazard and in the long run failing to develop autonomy.
- Social investors can link LCF groups to each other through networks and clusters, as can be seen in Nordic forest communities. Forest businesses tend to be remote from both markets and similar businesses. They may feel wary of sharing ideas and market intelligence with similar businesses; however the evidence shows that an open exchange of such ideas can benefit all units in the cluster, reducing costs and increasing margins. This is known as 'the economics of agglomeration' and can be witnessed, for instance, amongst leather goods manufacturers in Italy and woodcarvers in Bali.[54]
- The development mission of social investors, though not always helpful for building conventional business, can be used alongside private investment to deal with the wider social impacts

that may felt in transitional societies. They can thus be said to 'ameliorate the disordered faults of progress.' [55]

- Some of the social goals may need to be re-conceptualised as business goals. For instance, traditional knowledge does have a benefit to the business and contributes to the value proposition. Other goals may be achieved as a by-product of a successful business, e.g., youths stop drifting to cities because economic options improve at home, and thus improving community cultural cohesion.
- Access to AAA-rated finance, carbon markets and REDD+ interim funds can be used in partnership with the private sector to cover higher transaction costs of pioneering and intrepid investment strategies. These can demonstrate the viability of investing in LCF and disclose real risk profile and model investment returns, thus attracting follow-on investment from value investors.
- Among governments (who may also be seen as social investors) there is increasing momentum behind sustainable development planning at both the national and sub-national level. This may improve the chances of governance reform (e.g., tenure) where it can be demonstrated that such reform will have economic benefits and will enhance the value of REDD projects.
- Certain funding models that have social goals may be able to take advantage of tax breaks or a lighter regulatory regime. Hybrid models that aim for social, economic and environmental goals, whilst still maintaining the discipline to deliver a modest return to investors may resolve some of the other obstacles to social investment. For instance, the Cochabamba project in Bolivia uses an an 'Industrial and Provident Society' model which permits it to attract investors in the UK without the burden of becoming an authorized investment organization. Their investors may be satisfied with a lower rate of interest, and be philosophical about the risk of total loss; but it is also likely that they would prefer to see the project run in a business-like way with social and environmental aims that do not compromise financial returns for all shareholder, including the Bolivian farmers (see case study Appendix).

3.3 Conservation Investors

Needs / pre-conditions

- By definition conservation investors see investing in LCF as a means to an end to achieve environmental conservation goals. Conservation goals are paramount, which requires a local institutional mechanism to enforce forest management rules.
- Income generation may be confined to activities that do not disturb the ecosystem, (e.g., ecotourism) and may not be designed to yield much revenue for either the project or local rights-holders.
- Legal instruments are required that grant long-term rights over large area of forest with a clear demarcation of the managed forest area. This may be designed for conservation of a pristine forest or for restoration of degraded land.

- Increasingly, conservation projects expect to raise finance through either carbon sequestration or avoided deforestation. They may also raise income from selling other ecosystem services.

Challenges / obstacles faced

- **Competing goals**

  Although many conservation projects now acknowledge the importance of improving socio-economic conditions in order to meet conservation goals, they often encounter contradictions in the execution of their projects. In particular, local livelihood development is often an afterthought, and may in some cases be seen as incompatible with nature conservation. This can reinforce the impression that the costs of conservation are borne locally, whilst the benefits accrue far from the forest, as local usage value is subordinated to global 'option value.'

  There is a paradox at the heart of successful livelihood projects in conservation zones: they may become a magnet for other people, which puts pressure on the forest and may cause social problems (though this may be prevented by clearer tenure and local autonomy). Some NGOs may even prefer it if the diminishing economic prospects in the forests encouraged people to migrate to urban centres, as this would relieve the pressure on forest ecosystems.

- **Lack of commitment to local rights**

  In many cases, Governments see the state as the most appropriate freeholder for the forest estate, and thus often resist granting tenure to local rights-holders. Not all NGOs resist this tendency, partly because they fear that *'if you give the local people secure tenure then they will cut down the forest.'* [56] As the Brussels dialogue explained: *'Forest use by local communities is not recognized as an economic activity, but instead it is at times seen romantically as a means of subsistence in line with forest conservation or at other times as a threat to the sustainability of forests itself.'*

  Some of these perceptions may originate from well-funded and influential International conservation NGOs that have a tendency (though not always explicit) to conceptualise humans as an invasive species in the forest, and a driver of forest degradation.[57] Therefore, where such organisations use their influence to lobby for forest governance reform, it tends to be in the area of re-zoning areas and changing legal use, for instance from production forest to protected forest, regardless of real conservation value.[58] This re-zoning can reduce the livelihood options on offer to local rights-holders, and are often based on existing state forest boundaries which bear little relationship to actual boundaries as understood by the local people themselves. Once a forest has been designated as a protected area, it can be very hard to return it to more flexible use in the future.

  NGOs may utilise existing concession regulations to take over management of a threatened area, but the drawback of ecosystem restoration concessions is that in many regimes the leaseholder is forbidden from acknowledging local claims (see Conservation Sanctuary case study in Appendix).

Weak business models

The mistrust of community-led SFM amongst many conservation organisations means that economic options for local forest dwellers are constrained and sustainability of the conservation project is called into question. It seems that limiting the livelihood options available to forest communities in the name of conservation has not been successful in either protecting environmental services or tackling poverty.[59] Financing such projects in the absence of viable business models requires reliable long term funding, which may not be available far into the future, putting many years of conservation work in jeopardy when funds run dry.

As a way to secure revenue without resorting to direct exploitation of the forest, many conservation models now include carbon sales as an essential revenue stream, but the uncertainties over carbon markets since Copenhagen has made it difficult to sell long term credits at appropriate prices. The carbon business model is also weakened by the fact that investments are usually site-specific. Outside the conservation zone, the broader institutional context and forest governance remains unchanged, thus causing displacement, leakage and non-permanence of either REDD or bio-diversity aims. Depending on how REDD rules develop, this may place long term carbon revenue at risk, seriously undermining the business model. For this reason conservation NGOs tend to lobby for REDD regulations to be project-based rather then national or sub-national.

The business model that this engenders tends to be based on the 'paying poor people not to cut down trees' model, where local rights-holders are entitled to rent, on the understanding that they do nothing more strenuous or disruptive than acting as game wardens and occasional guides for wealthy tourists. This may lead to more trees (though this is unproven), but it will not necessarily lead to more empowered communities. In fact, local communities may become blighted by their dependence on rents from a local resource that they can no longer actively exploit. They will become, in effect, welfare claimants, with possible negative consequences for social cohesion.[60]

Conservationists are conservative

Conservation implies a disposition towards static equilibrium, where nothing moves, develops or changes. This may induce some conservation organisations to adopt a 'post development' stance to forest peoples, based on the theory that development is not in the best interests of Indigenous People. This may even induce a preference towards the more 'exotic' Indigenous People, who become contextualised as part of the biodiversity so long as they remain untouched by human development.

SECTION 4: SHARED OPPORTUNITIES FOR PROGRESS

The opportunities that exist for improved investment by all types of investor can be organised briefly under the key themes discussed at the previous dialogues (see section 2).

Legal and institutional

- Merge local understanding of rights with existing legal frameworks in order to 'encapsulate' those rights in a legible framework, whilst accepting that over time new legal forms will emerge as part of the process of wider institutional change.
- Smallholders and disparate communities assemble themselves in LCF organizations that act as an effective counterpart for investors.
- Design REDD models to reinforce the holistic nature of long-term carbon storage, ensuring benefit sharing with local communities becomes institutionalised in the model even if such rights do not yet have formal legal meaning outside the REDD framework.
- Notarise partnership and joint venture agreements in a trusted jurisdiction, and/or set up independent arbitration.
- International investors and REDD funds can use their influence to help governments understand the benefits of tenure reform that favours local control.

Autonomy and Identity

- Rights-holders are responsible for their own development and for working out how they adapt to progress (in partnership with NGOs, if necessary). Investors do not need to second guess such issues.
- FPIC is not just a CSR activity. It has strategic importance and improves the conditions for a viable business partnership with local rights holders.
- Increased autonomy is not just having the power to say 'no,' but also the confidence to say 'yes' when the deal is right.
- Local stakeholders need to conceptualise the business as a separate body, with its own rights and legal persona. It is owned (or co-owned) by the community, but its assets are not directly accessible by the community.

Community capacity

- 'Soft' investment in capacity building may help create the conditions for commercial investment to follow.
- Capacity building should include organisational development as well as technical training. In many cases this can be costed into the business model.

- Business skills and entrepreneurial acumen can flourish only if, over time, communities are exposed to price signals, market intelligence and competition. Thus investors are incubators rather than guardians.
- As business institutions develop, so leaders will emerge. Communities and investors will need to consider how to nurture leaders without disrupting existing social patterns.

Access to finance

- Both investors and rights holders should be assessing commercial opportunities in the first instance rather than local development needs.
- There is a need for models that demonstrate the value of holistic business models, but in the meantime specialism may yield better results.
- The transaction cost problem may be solved through aggregation and a portfolio approach with professional fund management. Some of the costs may need to be covered by social investors (e.g., donors).
- Security of collateral and cashflow issues may be partly overcome through innovative supply chain interventions (each of which may be a viable business in its own right), such as:
  - Raw material terminal, e.g., aggregating sawnwood and veneers for small furniture manufacturers
  - Warehouse Receipt Scheme that pays out instant cash on delivery of NTFPs using mobile phone technology, linked to a local microfinance institution
  - Equipment Leasing company, co-owned by clusters of LCF groups, the company can take on the capital expenditure for all businesses, obtaining credit on better terms than individual enterprises, and taking control of maintenance, etc.

Partnerships

- All parties need to understand the role of intermediaries in brokering and managing successful partnerships.
- Clusters and networks of LCF groups could assemble portfolios of potential investment projects across several regions in order to reduce transaction costs and minimise risk.
- They could also strive to achieve some kind of certified standard of transparency, financial management, etc., to support capacity building efforts and share best practice.

SECTION 5: ISSUES FOR FURTHER DISCUSSION

The key themes and opportunities discussed above can inform the discussion on ILCF in the following ways:

5.1 Bridging the gap

- How can 'rights' be correctly understood and applied to both LCF and investors?
- How can investors demonstrate that business goals are not incompatible with social and environmental goals (triple bottom line)?
- How can rights holders demonstrate that local control strengthens the forestry business case and mitigate risks?
- What are the ground rules and safety mechanisms for successful partnerships?
- How can all types of investor work together to design innovative financial models for LCF?

5.2 Building Investment Preparedness

- How can we get the buy-in from 'soft' investors to provide the funding that will be able to respond to the preconditions the rights holder groups have identified in the previous dialogues as essential for successful 'hard' forestry investment (e.g., land tenure and commercial forest product rights, mechanisms for converting this into collateral, developing organisations and capacity building, forming cooperatives and business organisations, networking, proper accounting, proposal writing skills, etc.)?
- How can 'hard' capital investors support and promote the establishment of these identified needs? To what extent can they be costed into the business plan?
- How can social and conservation investors make their projects more sustainable and able to attract value investors?
- What kind of regulatory, policy and institutional conditions would be required for investment in LCF?
- What is the sequence of institutional change that over time will improve social, environmental and economic outcomes in forests?

5.3 Identifying Concrete Actions

- What models exist of effective investment in locally controlled forestry? How can these be supported and improved by all stakeholders?
- How do we develop new and creative models of partnerships and funding mechanisms between LCF stakeholders and investors?

- How do we meet the market requirements for sustainability and legality? What tools exist already and where are there needs for further development (for example legal logging, certified sustainable forest management, fair trade and other tools in LCF)?
- What mechanisms can be put in place so that any new investments safeguard the rights of both forest rights-holders and investors whilst strengthening local autonomy and development?

CONCLUSION

Throughout the world, despite some advances, forests are usually contested landscapes characterised by conflicting rights and legal uncertainty. It is thus right to acknowledge that *'local control is a process'* [61] that would normally be expected to follow the natural social development path experienced by other rights-based campaigns, at length arriving at a solution that recognises the natural rights of forest-dwelling communities to control and manage their own land. However, the state of the world's forests, in the context of climate change and declining biodiversity, has led to the emergence of a 'crisis narrative' that threatens to undermine or even halt the progress on rights by reinforcing the sense of forests as a global commons rather than a landscape over which local people could be said to have 'rights.'

NGOs, donors and philanthropists promote projects that protect local people from the ravages of commerce and development, but with the outcome that development may be inhibited and cash income arise from rent rather than productive activity. Some argue that such projects are essentially unethical as they recruit poor people to a cause that is not in their interest,[62] and may induce a welfarist 'cargo cult' type mentality that undermines social cohesion and undermines the fabric of the community even more than more commercial forestry may have done.

However, the role of forests in mitigating climate change is beginning to attract investors that hitherto have been deterred by perceptions of risk and uncertainty. This represents an opportunity for rights holders and investors to work together for mutual advantage.

As the objective of promoting investment in locally controlled forestry is pursued in the context of value differences and competing goals, the rights-holders, investors and intermediaries face the prospect of accommodating trade-offs. For investors this may mean lower returns or longer periods before capital matures. For rights-holders it could mean embracing institutional changes that are alien and potentially disruptive. NGOs may need to temper environmental goals in order to pursue social ones, or subordinate social goals for the cause of improving the economic environment.

There is a need to identify successful case studies on financing community projects, and interpret the outcomes in terms of the goals of all the stakeholders. In many cases an early evaluation may dwell on the compromises that had to be made by the stakeholders, but over time it may become evident to what extent the benefits of the project outweighed the costs of such compromises.

ENDNOTES

1 Agreed definition by G3, Rome, 2010

2 Data from IFFA

3 TFD, 2010

4 Marx and Engels, 1848

5 LFP, 2009

6 GEF, 2009

7 The IFFA has suggested that improved statistics are needed by the LCF lobby—the same numbers tend to get re-circulated without proper fact checking, and the numbers I state here are no exception

8 Scherr, 2003

9 G3, Rome

10 Rhein, per cor. May 2010

11 Legallais-Korsbakken, per cor. May 2010

12 Degawan, et al., 2009

13 de Soto, 2000, p. 177

14 G3, Rome

15 Chhatre and Agrawal, 2009

16 Brown et al 2002

17 Eliasch, 2008

18 Wells et al, 2006

19 Brown et al, 2002

20 Engberg-Pedersen, 1997

21 Macqueen (2007) p. 2

22 Mongabay, 2010

23 Interview with Walesi tribal leader, Papua, Indonesia, April 2009

24 G3, Rome

25 "Where's the meat" is a common question posed to the author by investors

26 Simula, 2008, p. 12

27 Mbile et al, 2008, p. 7

28 Simula, 2008, p. 10

29 e.g., McKinsey, 2008 and Campanale, 2009

30 e.g., GEF (2010) shows US timberlands outperformed other asset classes over 1986–2008

31 Campanale, 2009, p. 61

32 World Bank/IFC, 2010

33 Also referred to as 'people, planet, profit'

34 Pers. Corr. With D. Vincent, Ethical Investments UK Ltd.

35 McKinsey, 2008

36 GEF, 2009

37 PWC, 2010, p.17

38 Emerging convention (e.g IFAD and UNREDD) is for developers to ensure inclusion of women. However investors may not be comfortable with this selective imposition of values.

39 Maturana et al (2005) found that expenditure on community development projects by pulp companies is 'misdirected and counter-productive,' and actually increases the incidence of land claims and disputes.

40 GEF, 2009

41 Arnold, 2001

42 McKinsey, 2008

43 Petley, per cor, April 2010

44 Using debt leverage increases the efficiency of the initial cash investment and increases IRR

45 'Over trading' is where a small company becomes a victim of its own success by purchasing inputs to satisfy larger orders for which payment will be delayed, creating a cashflow crisis

46 Sensitivity analysis applied to a community forestry business plan (Papua, Indonesia) shows the upfront cost of training reduces the IRR by less than 0.5% over 8 years

47 Campanale 2008, & Elson 2009

48 Campanale, 2009

49 Macqueen, 2007

50 Although some companies do have stakeholder representation and participation on the board to help shape strategic decisions, e.g., German works councils, they do not tend to put daily business decisions to the vote.

51 GACF, Rome 2010

52 It is not only NGOs that have this characteristic. Multilateral donors and financial institutions, such as the World Bank, are often staffed by people who have little commercial experience.

53 Per. Cor. with Scott Landis, Greenwood, May 2010

54 Elson, 2008

55 Cowen and Shenton, 1996

56 Comment at philanthropist's meeting by anonymous participant from a major conservation NGO, London, 2008

57 Cernea and Schmidt-Soltau, 2006

58 Swiderska et al, 2008

59 Scherr et al, 2003

60 Elson, 2007

61 G3, Rome

62 Mavhunga, 2007

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APPENDICES

APPENDIX A

Case Study: AFHAN—Cameroon

AFHAN (Association Femmes et Hommes Amis Nkolenyeng) was started in 2006 in partnership with CED, an NGO based in the capital Yaoundé. The association is based on managing 1200 hectares of forest (much of it logged-over and denuded of high value species) under a community forestry permit. The aim of business was to find a market for the lower value timber species that usually do not attract a good price, *'thus attaining development goals for the village, as well as empowerment and positivity.'*

AFHAN is a member of the Equifor trading group, which was set up by CED to act as the broker between community forests and French buyers seeking community timber. In 2007 they sold 65 m^3 of timber, at the rather low price of \$20/m^3. However, this money was not invested back in the business, but used for village development, to repair the borehole, buy a generator, and obtain some sports equipment for the children.

In 2008 they planned to sell 160 m^3 of timber, but as they started the year with no capital available to renew the felling license, they could not start cutting until October and by the end of the year had cut only 9 m^3. So even at the poor sales price of \$20/m^3, they have only achieved \$180 of income from a potential \$3,000. They are disappointed as no funds will be available for village development projects.

The group feels that they lack the equipment to raise productivity. They own three chainsaws, and the Husqvarna portable sawmill/band saw 'donated' by Equifor. They make familiar complaints about the Husqvarna mill: it is not very robust and does not seem to enhance productivity as the wood needs to be cut twice.

There is also a problem with team management. The trained operators (two fellers and two mill operators) have gone back to their cocoa plots, where they can make more money as the price of cocoa has risen recently. They are not really experienced enough to teach others in the village, and their skills (only recently learned) are getting rusty. The village has identified some younger men who are up for learning (they have no alternative income), but they will need to be trained by an outside agency.

Lessons learned

Have clear business goals. The key aim of the business should be to fulfil customer needs in a profitable manner and distribute dividends to the shareholders, in this case the villagers. How those dividends are then spent should not be the concern of the business.

Write a simple business plan. The business has no plan and thus no contingency for dealing with capricious local government permit regulations.

Run a basic accounts system. Even a very basic paper-based accounts system would demonstrate that most of the first year revenue needed to be kept in the business to meet future liabilities.

Acquire/lease appropriate equipment. The capital equipment has been donated by the NGO, but it was not fit for purpose and has no maintenance budget (parts must be sent from Sweden)

Sustainable businesses build trust. If the business were better run then it would be able to contract the staff it needs in an appropriate manner, and have a plan for training new staff.

Demand a business-like relationship with the NGO. The transactions with Equifor were opaque, and the price obtained by the NGO well below market rates. It seems the NGO felt that the gift of equipment would compensate for this lack of clarity, but in fact it contributed to the sense that the arrangement was not conducted on proper business terms.

Source: Field research by author, October 2008

APPENDIX B

Case Study: GreenWood—Honduras

GreenWood has experience over the last 10 years on the North Coast of Honduras, for instance setting up an initiative to produce guitar-parts with the community of Copen around 2000, which has since expanded to incorporate two additional communities in the buffer zone of the Rio Platano Biosphere Reserve of Honduras.

The investments in local forest enterprise have mainly taken two forms:

- **Purchase orders from the Taylor Guitar Company** (El Cajon, California). GreenWood essentially plays the role of an honest broker in the first transactions. Taylor writes the purchase orders to Greenwood, which subcontracts the work to a local partner NGO, Fundacion MaderaVerde (FMV), which in turn subcontracts the actual production to the sawyer's collectives in each of the three participating communities.
- **Grants or contracts for specific activities** (forest management, chain-of-custody activities, etc.) related to the productive enterprise in these three communities. GreenWood and FMV jointly collaborate in the planning and development of our proposals, and we coordinate their implementation, most of which is directly managed by FMV.

In the case of the guitar-part transactions, the investor's main concerns and interests fall into the following categories:

- Quality control
- Timeliness of delivery
- Legality of the source and participation/engagement of the community partners in the whole process
- Building a long-term relationship with all the partners in the transaction
- Threats of unfair, unequal or unethical competition from other parties.

In the case of the performance contracts, our donor/counterpart (USFS) is mainly interested in community participation, the delivery of beneficial skills and information that will enhance management effectiveness and control for forest communities. They are also interested in promoting a strong business relationship between the community groups and private-sector partners.

Lessons learned

Transparency plays an essential role at every level of this transaction. All financial information is shared with the groups and Greenwood continues to work closely with all partners to clarify costs and cash flow throughout the process.

The objective is for the communities to take ownership of as much of the productive process as possible, capturing the greatest possible value from their own resource. It is equally important that they understand all the steps in the process, even those that they are not currently capable of fulfilling—or may never be able to fulfill—such as the brokerage function and relationship with the client. All of these steps have a value and a cost that must be factored into and covered by the enterprise itself. If these costs were to be underwritten by a nonprofit entity or obscured within the transaction, the system will ultimately be unsustainable.

Sources: http://www.greenwoodglobal.org and personal correspondence with Scott Landis, President, Greenwood.

APPENDIX C

Case Study: Conservation Sanctuary—Indonesia

A substantial ecosystem restoration concession in Indonesia, supported by an international conservation organisation. The organisation is one of the few ICNGOs to include benefit-sharing and people-centred approaches in its policies. However, its concession is encountering difficulties There are 22 villages in and around the concession, and large numbers of rubber trees (and other agroforestry) within the concession that are deemed to be 'owned' by local people.

However, the NGO does not formally acknowledge any competing claims on the land, and in any case would be forbidden from doing so by the terms of its concession from the state. Local managers acknowledge that some form of benefit-sharing arrangement, perhaps through a joint venture company, may be a good way to get local people on board and prevent future incursions and erosion of the forest.

However, the international parent organisation is worried that any economic activity within the park will act as a magnet, attracting human incursion from both proximate communities and migrants alike, and preventing the ecosystem restoration from taking place. Their concern is that the locals agitating for access rights are themselves recent arrivals to the area—they do not have long-standing claims. This may be true, but of course the site assumes the boundaries of a former concession that was itself contested, and the incursion by communities when the former concession was wound up was a common event in what had become open-access land.

The institutional view seems to be that carbon credits will provide the income to pay for locals to patrol the perimeter of the park, but this fails to address the difference between 'jobs' and sustainable livelihoods, and thus runs the risk of making similar mistakes as the large industrial concessions that have had such a disastrous impact on Indonesia's ecosystem.

APPENDIX D

Case Study: Cochabamba Project—Bolivia

The Cochabamba Project Ltd. (Society) was established in March 2009 as an 'Industrial and Provident Society for the Benefit of the Community,' for the specific purpose of completing a reforestation project by approximately 2,000 smallholders in the tropical regions of the Cochabamba, Santa Cruz and Beni provinces in Bolivia. Revenue from the timber shared equally between the investor and the farmer, with the former providing investment capital and the latter providing land and labor. It has also been acknowledged for its role in mitigating the impact of climate change, having been accredited as a Clean Development Mechanism project under the Kyoto protocol. Furthermore, the project has been nominated for a Gold rating according to the Climate, Community & Biodiversity Alliance (CCBA) standards.

The wider project in and around the district of Cochabamba in Bolivia encompasses an area of 6000 hectares. As a result of an initial public share offer The Cochabamba Project Ltd. raised over £620,000 [USD 880,000] by 31st December 2009. These funds paid for the planting of 241 hectares within the project area, covering the purchase and germination of seedlings, the ground preparation and the planting of trees within the project areas managed by Arbolivia.

The participating smallholders in Bolivia provide the land and labor, whilst income from the sale of carbon credits to a European government helps to finance operational costs. In return for its investment in trees The Society will receive 50% of the future timber revenues, whilst the participating smallholders in Bolivia will receive the other 50% of the timber revenues.

The project attracts private investors and CSR foundations by presenting itself as primarily a social rather than a financial investment. However, the Society hopes to be able to pay interest on shares of up to 7.5%, which it proposes to accrue and pay when shares are withdrawn (as no interest can be paid for some years until the trees mature). Any surplus will be used benefit the local communities of the district of Cochabamba in Bolivia by promoting environmental sustainability and by tree planting in conservation areas in Bolivia. Because it uses the Industrial and Provident Society model, by law the project cannot offer a generous interest rate to UK investors, also the shares cannot be sold or traded and there is no prospect of them ever being worth more than their nominal value.

Main obstacles

- The main problems of finding capital are the inability to wrap the project up in an authorized investment vehicle that can be marketed in the UK
- The long wait until revenues accrue
- A misconceived perception of 'political risk'

- A total lack of understanding of forestry within the financial services industry
- Liquidity issues, or more specifically the lack of a defined exit route within an acceptable timeframe
- Failure of Copenhagen and uncertainties over carbon markets has made it impossible to sell long-term credits

Lessons learned

- Teaming up with an accredited CDM project makes it much easier to convince retail investors that this is a legitimate scheme
- Importance of having a clear focus which ticks financial, environmental and social boxes.
- The IPS structure effectively acts as an unregulated bank—with depositors coming and going over the years but the same capital being tied up in the project.

Sources: www.cochabamba.coop and personal correspondence with David Vincent, Ethical Investments Ltd.