3.3 Financing sustainable forest management in the Amazon

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Introduction

The Amazon Alternative (TAA)¹ is a public private partnership powered by IDH, the Sustainable Trade Initiative.² The partnership advocates for Forest Stewardship Council (FSC) certification of forest management and the chain of custody of companies and communities in Brazil, Peru and Bolivia. TAA also supports these enterprises to strengthen their business practices and their links with markets that value sustainable timber. Many of these companies and communities need operational and investment capital, but have no experience in dealing with the financial sector.

In order to make sustainable forest management (SFM) feasible, access to financing is crucial. For forest companies and financial institutions to be able to work together, several issues need to be addressed:

- lack of mutual understanding;
- quality of financing proposals;
- inadequate financial instruments, products and guarantee systems.

TAA joined forces with the Finance Alliance for Sustainable Trade (FAST)³ and SCOPEInsight⁴ to develop a set of services that help both forest enterprises and financial institutions to better understand each other’s dynamics, needs and opportunities.

Sustainable, FSC-certified forest management helps to manage risks (financial, commercial and reputational). This makes FSC-certified forest enterprises interesting potential clients for the financial sector.

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From “mind the gap”…
Most financial institutions (FIs) in Latin America have a profound distrust of forest companies, often based on bad experiences in the past. There is one main reason for these experiences: a lack of good understanding of the forest and timber sector on the part of FIs.

Credit officers find it difficult to assess loan requests because they don’t know what to look for: is this credible forest management or will it cause deforestation? What are the real assets? How can the cash flow be interpreted? What can be financed in the short term and the long term?

Inappropriate loans and subsequent losses for the FIs — combined with a growing overall concern about deforestation — makes banks hesitant to issue loans; they are also afraid of losses and of being accused of financing illegal logging.

Many forest management companies are not just tree-cutting ventures. Responding to legal requirements, market demand and/or a personal commitment to SFM, they take care of the forest, taking out a limited quantity of timber, with the intent to maintain the forest for future generations.

Usually, these businesses and community enterprises do not work with FIs for financing forest management; instead, they depend on informal sources of financing. Good investment proposals require time and the use of specialists to prepare the required paperwork; the forest companies don’t understand the need for all this paperwork and don’t believe the effort will result in a loan. This causes the FIs to complain about the quality of the funding proposals they do receive. In addition, forest companies don’t find financial products that are suitable for their specific needs.

This lack of understanding and the subsequent lack of formal financing forces many smaller forest enterprises to work with informal pre-financing from timber purchasers, who dominate the value chain and often charge high interest rates. This causes them to harvest more than is sustainable, and doesn’t allow them to capitalize themselves so they can improve their business practices.

... to bridging the gap
TAA and FAST implemented a strategic approach to this situation. They provide a SCOPE business performance assessment that helps companies opting for FSC certified forest management identify their strong and weak points and improve the latter. Companies with a good score can demonstrate the quality of their business performance and administration to interested FIs. These companies are also assisted in preparing their investment plans.

At the same time, FAST and TAA also organize training for financial institutions on all components of sustainable forest management, including its financial aspects. They support financial institutions to develop specific products that meet the needs of forest companies. The selected companies then meet with the financial institutions during round table sessions at a FAST Forestry Financial Fair (Table 1).
### Table 1. The step-by-step approach

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### Step 1. Preparing for investment

#### Step 1a: identification of forest companies

TAA and FAST focus on forest and timber companies/communities that are already FSC certified or on the way to certification. Being FSC certified implies that the enterprise is committed to sustainable forest management and that it meets strict social, economic and ecological standards. For companies on the way to certification, relatively small but crucial loans enable them to fund direct and indirect certification costs; they would not be able to finance these costs without such loans.

#### Step 1b: SCOPE profiles

SCOPEInsight assesses the business performance of forest companies, both private and community-based. This assessment is based on a specific methodology, Scoring of Organizational Performance (SCOPE), which uses an integrated and holistic approach. SCOPE is a broader assessment than a standard credit rating, which often focuses on the presence of collateral. Such standard ratings often turn out to be unrealistic in the forest context, which leads to many viable opportunities being excluded.

The SCOPE methodology assesses five main factors:
- internal management experience in key topics such as governance, operations and financial management;
- financial performance;
- risk management;
- sustainability issues; and
- management of supply and markets, which indicates how embedded the organization is in the value chain.

By assessing companies and producer organizations and offering the scores to interested financial institutions, insurance companies, traders, input suppliers and capacity builders, SCOPEInsight is able to bridge the information gap credibly and efficiently (Box 1).
Box 1. SCOPE in Peru and Bolivia
In 2011 a SCOPEInsight assessment was piloted among five forest companies in Peru and Bolivia, including international companies, family businesses and social community enterprises. Based on the results, the SCOPE tool was further developed and improved. In July 2012, SCOPEInsight profiled eight Peruvian forest and timber processing companies.

Step 1c: preparing the investment cases
Most companies have little notion of the paperwork required by the FIs. As a network of financial institutions and other groups, FAST has insight into the requirements of a financing proposal and related documents. TAA and FAST co-finance the assistance of local experts, who help companies prepare their proposal and complete the set of related documents (Box 2).

FAST does a final check of the quality and completeness of the proposals and related documents. A summary of each proposal, along with a summary of the SCOPE assessment, is then presented to FIs at the FAST Forestry Financial Fair (see Step 3). These “blind profiles” do not show the identity or further details of the company making the proposal. Once FIs subscribe to the fair they receive access to the complete file and SCOPE assessment profile. The FIs then indicate which companies they would like to meet.

Box 2. Help in preparing financing proposals
In 2011, seven Peruvian forest managing companies were supported to prepare their financing proposal for the FAST Forestry Financial Fair in April of that year. During the second quarter of 2012, nine Bolivian companies (private and community enterprises, forest managers and timber processors) were assisted for the fair in June 2012. In September 2012 eight Peruvian companies (forest managers and timber processors) received support in preparing their proposals for the fair in October 2012.

Step 2. Providing information about financial products
Step 2a. Crash course on sustainable forest management
During a workshop, executives of financial institutions receive an introduction to sustainable forest management and the financial dynamics involved. During one and a half days, professionals from the sector explain all aspects of forest management, including legal issues, real/perceived risks, financial dynamics, certification requirements, social obligations and market trends. Stakeholders involved in SFM in the specific country present themselves and explain their role; they included governmental institutions, certification bodies, NGOs and associations of timber exporting companies (Box 3).
Box 3. Workshops in Peru and Bolivia

In 2011 six international institutions and two local financial institutions participated in the first workshop, held in Lima, Peru: IFC, Root Capital, Rabobank Rural Fund, responsAbility, Project CAMbio of the CABEI, IDEPRO (Bolivia), Asesorandes and FOVIDA. As a result, two financial institutions that had never worked in the forest sector are now piloting their first loans and/or developing specific financial products for the forest sector.

In June 2012, the second workshop in Bolivia counted with the participation of two international FIs and four local FIs: responsAbility, Oikocredit, FIE, CIDRE, IDEPRO and Pro RURAL. For this training, a group of contracted experts developed a Forestry Financial Guide on sustainable forest management.6

In October 2012, a third workshop was held, attended by four FIs: COFIDE, FOVIDA, Agrobanco and IDEPRO. The guide was adapted to the specifics of the Peruvian timber sector (see Endnote 2).

Step 2b: development of specific financial products

TAA supports the development of a guarantee mechanism for financing forest management in Peru by COFIDE. Various local FIs are being coached to develop financial products for the forest sector, based on concrete business proposals from forest management companies.

Step 3. FAST Forestry Financial Fair

After these preparations on both sides, the forest and timber companies meet with the FIs during a FAST Forestry Financial Fair (FFFF). During round table meetings, the timber companies present their investment plans, show their SCOPE profiles, begin negotiations with the FIs and agree on where and when to follow up (the meetings last only 50 minutes). After each meeting the FI and company fill in a short evaluation form and outline their expectations regarding an actual loan (Box 4).

Box 4. FAST Forestry Financial Fairs

During the first FAST Forestry Financial Fair (FFFF) in Lima, May 2011, seven proposals were presented to six FIs, involving a total of almost US$ 23 million. Amounts per proposal varied from US$ 50,000 to 12 million. The forest companies and FIs held 22 bilateral meetings to discuss financing opportunities.

Three of the participating companies achieved a loan: one was from an international FI that was present at the fair; and two were from local financial institutions that did not attend the fair, but who valued the companies’ complete and well-organized documentation.
During the second FFFF, in Santa Cruz, in June 2012, almost US$4 million in potential investments were negotiated in 36 one-on-one meetings between the export-led small and medium forest enterprises and the financial institutions. Two loans that were already under negotiation were formalized. More loans are being negotiated.

A third FFFF was held in October 2012 in Lima: six forest and timber companies and seven financial institutions negotiated a total of US$3.5 million for loans and investments during 25 bilateral meetings. Further negotiations on possible loans have just started.

Step 4. Follow-up
Meeting during the FFFF helps build a relationship between a forest company and the FI. Intensive follow-up is needed in order to maintain the enthusiasm and dynamics developed during the workshop and fair. The evaluation forms help to indicate which meetings will most likely result in a loan. FAST maintains contact with the FIs and TAA assists the companies in maintaining communication, responding to additional requests for information and other tasks.

The evaluation forms from the meetings that do not result in a loan provide relevant information, including why expectations did not match, what was lacking in the presentation of the business cases, and whether the financial product was inappropriate or too expensive. This helps TAA and FAST improve the completeness and quality of proposals for subsequent fairs and gives input for the development of financial instruments.

Lessons learned
Since 2011, many lessons have been learned and incorporated to enrich and improve the approach.

Building a bridge takes time
It takes time for parties to understand each other, to build a relationship and the needed trust, for the company to believe the approach might work and invest in additional paperwork and controls, for the FI to understand what it needs to know about SFM, and to involve a timber client whose purchasing commitment can guarantee the success of the forest project. This is why it can take up to nine months to approve a loan.

Conflicting requirements
It is difficult for FIs to develop specific financial products for the companies at a sufficiently early moment in the process, especially FIs who have little experience in the forest sector. This causes a paradoxical situation: companies want to invest time and resources in a funding proposal only if they know what the FIs will offer; and FIs commit to come to the fair and consider negotiations only after they know what the company’s is proposing.
Commitment within the FI
Even if bank employees at the local level become convinced of the feasibility of the forest business case, much depends on the interest and commitment of the higher strategic levels of the FI. This is a challenge that only international operating institutions — that know both the forest and the financial sector — can help to advocate for. And as more and more FIs gain positive experiences with financing forest and timber companies, they may incorporate financing of sustainable forestry in their overall policies and structures.

An enabling regime
An enabling regime is needed that creates the conditions for sustainable forest and timber companies to strengthen their business case. Local governments, for instance, need to be lobbied on such matters as allowing standing timber in forest concessions to be considered as a guarantee; halting the competition of cheap illegal timber; promoting the demand for sustainable timber by requiring it in their purchase orders; and providing capacity building in financial and business administration.

Local professionals
A significant effort has to be made to increase the number of local professionals who have good knowledge of the timber and financial sector and who can assist companies and FIs in this process of mutual acquaintance and negotiations.

Where do we go from here?
Although huge progress has been made in a year and a half, much remains to be developed, improved and scaled up. The first FFFF included only private forest managing companies; the later FFFFs in 2012 also included community enterprises and timber processing companies. In the upcoming years, the approach will probably include business proposals based on harvesting and processing of non-timber forest products and/or environmental services.

Most companies that came to the first FFFFs had already developed their administrative and business case, so they needed relatively little support to prepare their proposals for the fairs. Now the moment has come to invest in private and community enterprises that need more time and support to improve their financial administration and business performance and come up with a feasible investment plan. In the coming years, support for the preparation of business proposals needs to continue and even increase. The SCOPE profiles will be a good tool to set the baseline, define where to start and monitor progress.
So far, the results are reflected in the output, i.e., in the number and value of loans issued. But that is not what this is about; the real impact should be seen in strengthened sound business cases based on SFM. Monitoring of two aspects of the approach is needed:

- outcomes — are payments made in time? Is renegotiation necessary? This will help to improve the approach, development adequate instruments and sharpen criteria; and
- impacts — FAST is involved in the development of a monitoring instrument on the environmental, social and financial impact of the loans. The improvement of the business case can also be measured by a regular update of the SCOPE profile.

More companies want to take part, but sometimes miss the financial fairs. Companies with more capacity and experience don't need the FFFF; they can present their proposals directly to FIs that have increasing experience with the sustainable timber sector. Furthermore, FIs that gain more experience in the forest sector look for other, more dynamic ways of finding potential clients. Therefore, FAST will start showcasing proposals of forestry and timber companies in the virtual FAST Financial Marketplace all year round. In addition, SCOPEInsight's database, which is consulted by FIs looking for interesting clients, will include more and more profiles of forest companies. This means that from 2014 on, the costs to match FIs with business proposals will diminish, since more matching will be done virtually.

**Conclusions**

It could be said that past performance is no guarantee of future disasters. Financing sustainable forestry can be a good option for FIs to expand their portfolio as long as they understand the dynamics of the forest sector and consider the real risks. It takes effort from both companies and FIs, but successful examples of financing sustainable forestry management do exist.

It is hoped that these experiences will convince governments to provide the adequate enabling regime and will encourage the financial sector to incorporate sustainable forestry in their policies and portfolio and provide sufficient financial and human resources, capacities, products and procedures for these relationships to flourish in more regions.

**Endnotes**

1. See www.theamazonalternative.org.
5. For more details on FSC, see www.fsc.org/principles-and-criteria.34.htm.
6. For more information about the guide (in Spanish only), see www.fastinternational.org/files/Guia%20Financiera%20Forestal%20Bolivia%202012_3.pdf.