

Policy pointers

Financing mechanisms for forest-related enterprises that are too big for micro-finance but too small and risky for conventional banks must be strengthened to avoid deforestation while also reducing poverty.

Helping enterprises to aggregate and add value to products and services and represent producer interests in decision making is necessary to achieve scalable transformational change through the Forest Investment Program and other similar programmes.

Finding ways to house and sustain business incubation services in forest landscapes beyond project cycles is a critical issue for successfully engaging small- and medium-sized enterprises in forest climate action.

Innovative financing mechanisms are being found to de-risk investments in forest-related businesses, but these need to be documented, shared and then transferred and replicated.

Financing forest-related enterprises: lessons from the Forest Investment Program

Financing forest-related enterprises in ways that reduce both deforestation and poverty is critical to climate action and sustainable development. Yet it is challenging. The Climate Investment Funds (CIF) 'Evaluation and Learning Partnership on Financing Forest-Related Enterprises' (ELPFRE) is looking at ways of improving access to and leverage of finance from the private sector. Early findings suggest that on the spectrum from micro livelihood investments to large debt or equity investments lies a challenging weak or 'missing middle', with a potentially very high multiplier effect for CIF. Emerging questions to tackle this 'missing middle' should now be focused on scaling up for greater efficiency, the best way to improve forest enterprise through business incubation and ways to reduce the risk of investing in these businesses.

Introduction to the learning partnership

The private sector has a key role to play in addressing the drivers of deforestation and forest degradation, and improving livelihoods. There are barriers and risks, however, which need to be overcome for its effective engagement, particularly in the Forest Investment Program (FIP). IIED and LTS have worked together to facilitate the Climate Investment Funds (CIF) Evaluation and Learning Partnership on Financing Forest-Related Enterprises (ELPFRE). This learning partnership drew on recent forest investment literature^{1,2} and research on financing small- and medium-sized enterprises (SMEs)³ to put forward an 'enabling-to-asset investment' learning framework. This sought to find out what forms of 'enabling investment' (eg to deliver

secure commercial rights, technical support, business capacity and organisation) were a necessary precondition for what forms of 'asset investment' (which expects a financial return).

In any forest landscape, there is likely to be a wide variety of potential forest-related businesses ranging in scale from informal smallholders to large multinational corporations and cooperatives. These may be engaged in a range of value chains including products relating to biomass energy, timber, non-timber forest products (NTFPs) and services. Businesses seeking to develop these value chains may have a corresponding range and scale of investment needs. The 'biggest private sector' is the collective mass of micro, small and medium enterprises (MSMEs) not yet effectively reached by public or conventional financing institutions. In this context, ELPFRE harvested lessons

There are risk-takers out there committed to business incubation of local producer groups

from different types and models of financing tested in the FIP, as well as non-CIF investments, aiming to apply learning to ongoing and planned forest investments. Currently

21 countries have developed FIP investment plans that include enabling investments to the private sector through policy and institutional work and capacity development.

Emerging learning and questions on scaling-up

Invest in the weak or 'missing middle' (see Figure 1). Overcoming barriers in this sector has been widely discussed.^{4,5,6,7} While categories of investment are imprecise and often overlapping, complicating accurate quantification, the general pattern of financing models within the FIP is dominated by investment in the micro/alternative livelihood income-generating activities (approximately 53%) and in improving the enabling environment (policy and capacity) (approximately 41%). Across the portfolio, less than 3% of investment goes to technical assistance and business incubation tailored to SMEs and only the same to concessional loans blended with market-rate capital for large-scale lead firms, mainly to promote forest plantations.

Clearly, FIP is prioritising investments to develop a conducive policy environment for bankable businesses. It is also investing heavily in the micro/alternative livelihood scale of the private sector spectrum. The expectation is that this will be sustainable and take pressure off forests — but will it outlast the project support? Investment in the large scale and in the small and medium scale is taking place but at a much lower intensity. FIP has an opportunity to build on this foundation by reaching into the weak or 'missing middle' for transformational change. Developing this is important for scaling-up, formalising revenues from, and incentivising sustainability for, a growing set of alternative livelihood businesses, as well as providing opportunities for large-scale companies to extend further down the supply chain.

Support aggregators. Aggregation is a key tool to break into the weak or 'missing middle'. Building a complete understanding of how smallholders might best organise to facilitate access to value chains and markets (timber, cocoa or NTFPs) is an integral part of financing and implementing sustainable enterprises and there are UN programmes focused on strengthening organisations from whom

lessons could be learned (eg Forest and Farm Facility — FFF).

Provide the right incentives. Profit sharing and the sale of carbon credits can be attractive to intermediaries who then act as aggregators and guarantors of conventional investments into sustainable land use (eg cocoa in Peru overseen by Athelia). Access to capital brokered by such intermediaries can be a powerful incentive for smallholders to aggregate into group enterprises (eg the AIDER cooperative in Peru) with strong sustainability imperatives. While the country study in Lao PDR indicated past challenges of producers honouring supply agreements, this only highlights the need to invest in capacity building to ensure compliance.

Better understand out-grower schemes.

Investment in this weak or 'missing middle' is complicated because it is usually only large-scale lead firms that comply with the good business practices required by multilateral development lending banks. The expectation, particularly in the plantations, is that these firms then engage SMEs in out-grower schemes. But are such investments effective in stimulating engagement of SMEs and reducing the transaction costs of including them in the value chains?

The context and enabling factors for scaling-up in a country may be different so adaptive learning is important. An emerging question around scaling up might be:

- **How can multi-tiered organisations be created that group local producers, aggregate, add value to and market their products, and represent their interests with decision makers?**

Emerging learning and questions on business incubation

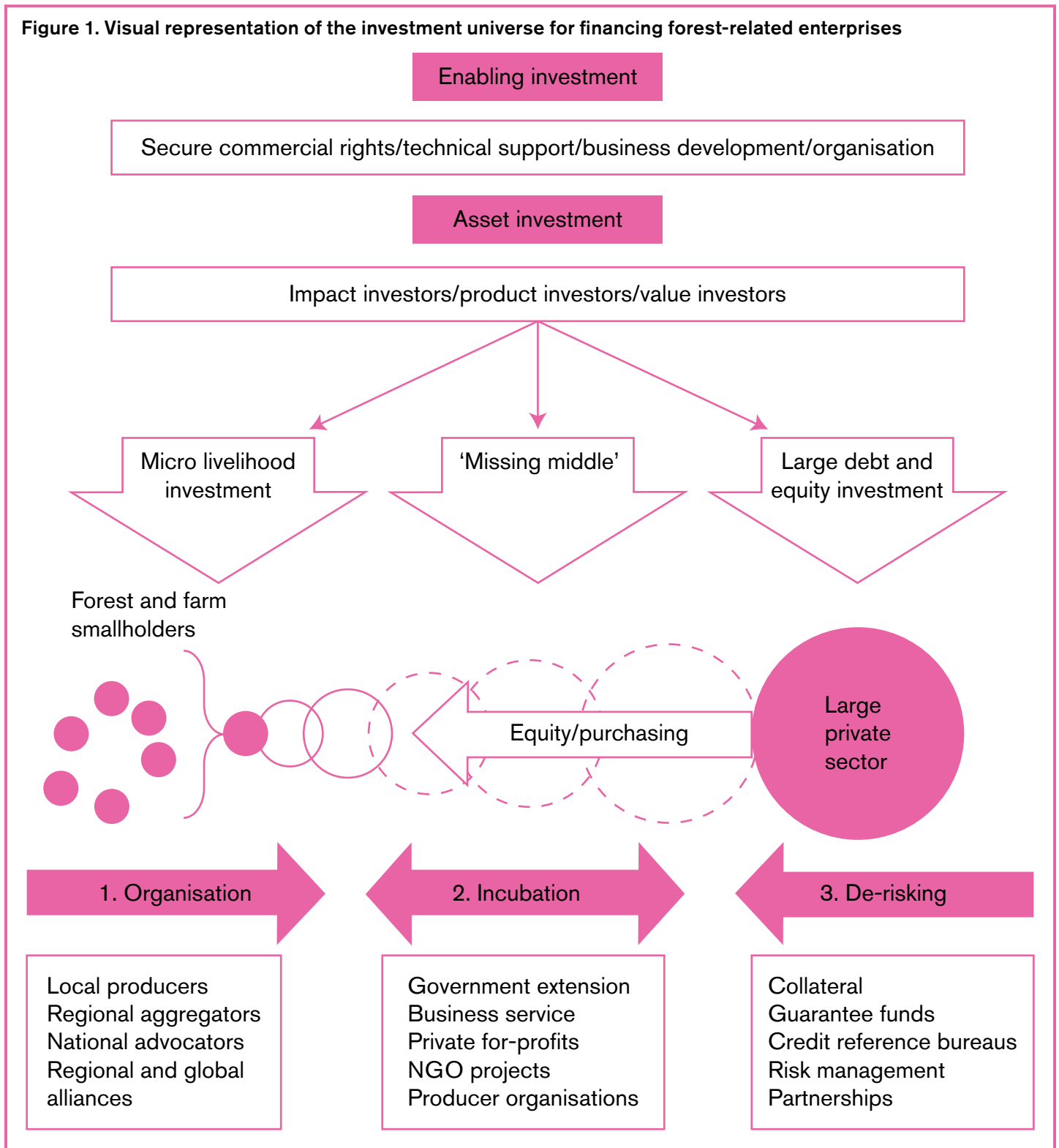
Support local business incubators.

Combining technical support with business capacity development for producers requires local business support to ensure integrated environmental, technical and business knowledge is passed on to producers. Training and accreditation of this kind will help build a service provider network. This can be backed by grant or loan conditionalities to producers for good technical and environmental practice, such as in the Sawlog Production Grant Scheme (SPGS) in Uganda overseen by Unique.

There are risk-takers out there committed to business incubation of local producer groups. An emerging learning question might be:

- **In what institutional formats (government, NGO, private for profit, producer**

Figure 1. Visual representation of the investment universe for financing forest-related enterprises



organisation) could business incubation be made both sustainable and accessible to those in forest landscapes?

Emerging learning and questions on de-risking

Establish public-private partnership. There are many risks in forestry-related investment: **resource related** — slow growth of high value

timber species, fire, pests and diseases; **revenue related** — scale and technology availabilities and efficiencies; **relationship related** — market and business network information, and so on. Mitigating these risks calls for parallel financing of research and development. Public-private partnerships are particularly well placed to use FIP to strengthen the capacity to reduce risks through building technical and business knowhow in MSMEs.

Implement conditional payment backed by innovative monitoring schemes. Financing arrangements can contractually integrate financial performance with environmental compliance against set standards (eg land management agreements by F3 Life in Rwanda, which could include tree planting), all overseen and aggregated by third party intermediaries. Good land management practices and social media photographic monitoring can improve prospects for loan repayments, while also incentivising smallholder environmental responsibility.

Risk assessment. De-risking can be addressed in part through organising and building risk self-assessment capacity into cooperatives or other forms of aggregation. Work on strengthening MSMEs across Africa, Latin America and Asia has shown that apex organisations are cost-effective structures to build viable, sustainable and inclusive enterprises that can be scaled up within landscapes. The micro income generative enterprises supported by FIP in Laos, for example, can capitalise on existing enterprise associations.

Innovation on collateral. De-risking equally entails creating innovative ways of dealing with collateral, creation of credit reference bureaus and scoring services for low-income growers to build credit worthiness, and making use of carbon finance or credit guarantee funds.

Working with large firms to reach out to the weak or 'missing middle'. Financing lead firms who can pass on credit to MSME suppliers is another way to ensure recovery of

loans, compliance with environmental and social standards, and reduction of transaction costs of servicing debt by financiers. As both FIP and non-FIP projects highlighted, creating financing mechanisms, such as revolving funds rooted in the local needs and management capacities, can ensure that not many producers are left behind. This need not always be interest free. Introducing even modest interest rates can build robust enterprise finances in the medium- and long-term.

Learning on effectiveness of guarantees from within the FIP portfolio as well as non-CIF could be capitalised on and scaled-up under an emerging learning question:

- **How can systems of collateral, or guarantee, or risk management or partnership be scaled-up to de-risk investment in forest-related enterprises for different types of asset investor?**

The three areas of enquiry above could help to improve the transformative impact of FIP investment and shift the focus towards building institutional capacity among isolated producers, developing technical and business capacity among MSMEs, and creating de-risking measures for financing them in FIP countries.

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Notes

¹ Elson, D (2012) Guide to investing in locally controlled forestry. Growing Forest Partnerships in association with FAO, IIED, IUCN, The Forest Dialogue and the World Bank. IIED, London. / ² Macqueen, DJ, Buss, C and Sarroca, T (2012) TFD Review: Investing in Locally Controlled Forestry. The Forest Dialogue, New Haven, USA. / ³ Nhamumbo, I, Hou-Jones, X, Bolin, A and Warren G (2016) Unlocking barriers to financing sustainable SMEs: uphill struggle or attainable ambition? IIED, London. / ⁴ FAO (2017) Forest and Landscape Investment Forum - Unleashing Business Opportunities for Sustainable Landscapes. FAO, Rome. / ⁵ World Bank (2013) Report of the Forest Investment Forum - Investment Opportunities: Constraints to Investment and Potential Solutions. World Bank, Washington, USA. / ⁶ World Bank (2016) Eastern and Southern African region forest investment forum - Investment Opportunities: Constraints to Investment and Potential Solutions. World Bank, Washington, USA. / ⁷ Castrén, T, Katila, M, Lindroos, K and Salmi, J (2014) Private Financing for Sustainable Forest Management and Forest Products in Developing Countries: Trends and drivers. Washington, DC, USA. Program on Forests (PROFOR).