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Private Capital Project

Impact Investing: How Does It Fit into the Broader Capital Markets? Case Studies from the Forest Conservation Sector

On September 29th, 2020, the HBS Club of DC led a panel discussion about conservation-focused investing in the forestry sector. The discussion explored not just issues in this particular asset class, but the investment community's expectations about the potential of impact investment more generally. The HBS Private Capital Project and the Private Capital Research Institute are distributing this summary due to interest in the discussion.

Preserving forests plays a critical role in the fight against climate change and preserving biodiversity. Due to limited government funding, alternative approaches to forestland ownership and management have emerged. Such approaches focus on blending conservation goals with private investments. But simultaneously achieving successful returns and conservation outcomes remains challenging. This conversation focused on two case studies, one on a novel green bond offered by The Conservation Fund designed for investors seeking financial and conservation returns, and the other on a sustainability-focused fund-of-funds that makes forestland investments.¹

The discussants were **Matthew Arnold** (Head of ESG and Corporate Responsibility Engagement at JPMorgan Chase), **Clark Binkley** (Managing Director at International Forestry Investment Advisors), and **Ratnika Prasad** (Director at the Environmental Defense Fund). Special commentators were the two case protagonists, **John Gilbert** (Executive Vice President and Chief Financial Officer at The Conservation Fund) and **Rick Weyerhaeuser** (Senior Natural Resource Strategist and Director at Sonen Capital). Josh Lerner of HBS served as the moderator.

¹ Baxter, Andrew and Cash, Connor and Lerner, Josh and Prasad, Ratnika, Two Case Studies on the Financing of Forest Conservation (June 23, 2020). Harvard Business School Finance Working Paper No. 20-137, Harvard Business School Entrepreneurial Management Working Paper No. 20-137, Available at SSRN: <https://ssrn.com/abstract=3640706>

In recent years, interest in impact investing has increased globally. The financing of forest conservation has been one manifestation of this phenomenon. But the path for forest conservation finance has not been smooth.

Impact investors have been intrigued by this space for several reasons. First, using public financing as the only solution to large environmental and social challenges is often inadequate. For instance, the UN Convention on Biological Diversity (CBD) estimated that at least \$150 billion per year needs to be mobilized to close the gap between current funding for nature conservation and needed funding.² This figure is based on achieving the CBD's twenty Aichi Biodiversity Targets, which aim to properly conserve nature and its resources.³ Second, in the investing space more generally, there has been an increasing appreciation of the benefits that real assets can bring to a portfolio. Third, numerous investors, whether families or endowments, are increasingly demanding that their investments complement their broader goals.

Challenges

The panel began with a discussion of challenges highlighted in the HBS case studies, "Two Case Studies on the Financing of Forest Conservation." First, there is a lack of investment opportunities of scale in the forestry sector. On aggregate, there is a large need for investing in the forest conversation space. But on a project level, the modest size of many investments can make it difficult to attract institutional investors.

Second, deals and investments must be carefully crafted, since actions to boost financial returns can degrade conservation outcomes, and vice versa. Investments that generate both a desirable return and a meaningful impact can be difficult to find.

This difficulty relates to the falling returns in the timber sector more generally. In the 1990s, annual returns timber investment funds were frequently in the mid-teens. But since the early 2000s, they have fallen to the low single digits.

These poor returns reflected the changing dynamics of the timberland investment sector. The rationale for timberland investments originated with the restructuring of the integrated forest companies. These firms, which had traditionally held large swaths of forest, sold off timberland to investors. Many investors were attracted to the attractive prices of these sales, and obtained decent returns. Over time, however, institutional investors increasingly traded forest properties amongst

² The CBD's Strategic Plan for Biodiversity 2011-2020 can be found at <https://www.cbd.int/doc/meetings/fin/hlpgar-sp-01/official/hlpgar-sp-01-01-report-en.pdf>.

³ See the Aichi Biodiversity Targets at <https://www.cbd.int/sp/targets/>.

themselves, leading to a “zero sum game.” Moreover, timber prices have been falling for quite some time. Thus, returns are harder to generate. These disappointments in timberland investing in general have spilled over to those seeking to raise capital to finance forest conservation.

Third, understanding which metrics matter is critical in measuring impact. On a global scale, there is a lack of institutions that can certify the credibility of these investments and stipulate the best metrics. This circumstance means that it is unfortunately not uncommon to see investment groups “greenwashing,” or overemphasizing or misleading investors about their environmental or social impact. Of course, other firms make an effort truly to understand the sector. These more credible firms typically are investing heavily in accurate metrics to measure the impact, which allows them to more credibly convey the consequences of their investments. Work must still be done to ensure that forest conservation impact investments fit within a credible regulatory framework.

A final challenge relates to the geographic distribution of projects. While unprotected forests exist at scale in many emerging economies, forest conservation projects have been concentrated in North America. In many cases, investors struggle to find trusted intermediaries to work with in markets such as Russia or Zambia. Concerns about the strength of property rights and reputational risks may also deter their involvement in emerging markets.

New Developments

At the same time, there are some encouraging developments. One of these has been the growing sophistication in this space of non-governmental organizations (NGOs) and development finance institutions (DFIs) such as the Global Environmental Facility (GEF). There is now widespread recognition that forestry programs that occur at a national or provincial level are needed, in order to ensure investments of sufficient scale. These groups are building their skill sets in order to be able to better identify if a project is financeable and if so, how it should be structured.

An important capability for these forest project originators is thinking creatively in response to the low returns challenge. These investors are increasingly tapping into alternative revenue streams, such as water management and especially carbon, to get a combined return equating to the middle-to-upper single digits. Thus, if a property can extract value from multiple sources of revenue, higher returns may follow.

A second encouraging development has been the interest of large banks in climate change-related finance. These organizations traditionally have focused on energy and fossil fuels. Moving to renewable energy investment receives the most attention to respond to climate issues. The discussants suggested that it would be unlikely that the banks would focus on forest conservation per

se, but may well be interested in climate mitigation strategies that involved climate-smart agriculture or forestry approaches.

The involvement of banks was not likely to take place overnight. In particular, large banks face intense regulatory scrutiny, particularly in the U.S., which may dampen the speed of their involvement with such investments. Furthermore, within large banks, the motivation to optimize performance vis-à-vis environmental and social issues differs: some see pursuing social goals as part of the bank's mission, while others will be far more interested if the projects are commercially viable. A combination of inside allies, outside pressure, and new economic opportunities can help bridge this dichotomy of doing the right thing versus doing for a living. If projects with returns and social goals are in place, large banks are also more likely to be more active.

Panelists emphasized the importance of new investors who value climate concerns. High-net-worth individuals (HNWI) have a crucial role in this space. These investors may be willing to accept financial returns below that of the market opportunities (though while still preserving capital), assuming the environmental benefits are compelling enough. For instance, after The Conservation Fund or another NGO has purchased a property and put conservation restrictions in place, HNWIs could buy the forests. HNWIs could also play a positive role by investing in timber funds that focus on conservation issues or even investing directly in timberland.

At the same time, these challenges cannot be solved solely by NGOs, HNWIs, or the financial sector. There are also important public policy changes that could facilitate these activities. Panelists noted that most of the carbon sales in forestry stem from the California market. Although California has a carbon market, the state's laws are constraining. For instance, the Climate Action Reserve (CAR), a carbon offset registry and successor to the California Climate Action Registry, has a Forest Protocol (FP) that favors dense forests.⁴ Thus, forests that have a higher timber volume relative to the regional average are more likely to obtain carbon credits than those below the regional average. Forests may be below the regional average because they have been recently harvested, so they must depend on their trees' growth rates to obtain carbon credits. Even if forests that are below the regional average eventually reach a high density of trees, forests that begin their carbon sequestration projects with high density are at an advantage due to the calculations under the CAR FP.⁵ To curb this problem, panelists discussed planting additional trees, but California law does not give credit for such a

⁴ See the CAR's FP at

https://www.climateactionreserve.org/how/protocols/forest/#reserve_guidelines_for_aggregating_forest_projects.

⁵ https://masswoods.org/sites/masswoods.org/files/Selling-Carbon_0.pdf.

maneuver. Going forward, if laws are improved and more credible carbon markets emerge, positive change can be made. For instance, if the Intermountain West did not have California regulations but had California carbon prices, forest rotations would extend by ten years.

The panelists stressed that more general public policy direction is needed to encourage forest landowners to participate in carbon markets. Like the carbon market, the impact investing space more generally is impacted greatly by public policy and tax law. There is much room for improvement to encourage and incentivize capital to flow to socially beneficial places.

Final Thoughts

While there are success stories, such as The Conservation Fund's Green Bond, the impact investing space still faces challenges. Investors are searching for larger deals; forest conservation organizations are seeking better approaches and instruments to raise capital; and the financial community is looking for reliable metrics data. Nevertheless, as the space matures, increased involvement and innovative financing strategies are expected.