



## 2.2 Rethinking investment in locally controlled forestry

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### Introduction

The Forests Dialogue (TFD) has facilitated nine dialogues throughout the world, with more than 300 participants from many different backgrounds. These initiatives tackle the challenges facing locally controlled forestry and determine how more investors can be encouraged to take a serious interest in the sector. It is the first time that investors and forest rights-holders have come together to discuss these issues in such detail. The culmination of this work is a detailed guide for investment in sustainable local forest enterprises (Elson 2012a).

This article applies some of the key concepts presented in the guide to two case studies. These case studies illustrate the challenges to investing in locally controlled forestry and the potential solutions. The guide itself provides much more detail on designing investment models, the process of building a business and the ingredients for success.

The term *forestry* refers here to small- and medium-sized forest enterprises (SMFEs). Experience shows that building this enterprise sector is both the means by which locally controlled forestry will be possible, and the only way in which it can be financially, environmentally and socially sustainable.

### Locally controlled forestry

Locally controlled forests involve one billion people and one quarter of the world's forests. They provide \$75–100 billion each year in goods and services and a broad range of other economic, environmental, social, cultural and spiritual benefits.<sup>1</sup> Rights-holder organizations such as the Global Alliance of Community Forestry, the International Family Forest Alliance and the International Alliance of Indigenous and Tribal Peoples of Tropical Forests, known collectively as the G3, define locally controlled forestry as follows:



LOCALLY CONTROLLED ENTERPRISES ARE A GOOD WAY TO ACHIEVE SUSTAINABLE ECONOMIC AND FINANCIAL RETURNS FROM FORESTS.

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*“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.”*

Local forest rights-holders have substantial — and growing — decision-making power and control over forest land but do not necessarily have tenure or ownership rights. This is certainly the case in most developing countries. On the other hand, there are also 25 million forest owners in North America, Australia and Europe who fit the description of locally controlled forestry and who have clear tenure.

From a development perspective, locally controlled forestry has clear benefits: it implies local participation, decentralization and equity. It can also be seen as a superior forest management system compared to top-down state or corporate control, 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.

### Investing in locally controlled forestry

The way in which many forests have been managed in the past 60 years has not led to good outcomes for either the forests or the people that live in them. Carving up forests into large industrial concessions has not usually led to trickle-down benefits for forest communities. Conservation areas and national parks have had mixed results; they often bypass local people’s rights and thus fail to build effective partnerships or a model of economically and socially sustainable forest management.

Microfinance for tiny boutique businesses serving niche markets and heavily supported by donors may be a useful first step, but it is often hard for such enterprises to make the change to become a self-sustaining business. The problem with this approach is that when the resources are exhausted or the grants are no longer available, the local people are often left worse off than before. This goes some way to explaining the persistence of poverty among forest-dwellers.

Building sustainable economies in forests may result from the formation of a thriving SME sector, where the rights-holders have a meaningful stake. SMEs are the “missing middle” of many developing economies, and unlike either micro-enterprises or large-scale plantations and concessions, they can provide improved access to goods, services, high-quality employment opportunities and markets. They are a way for forest communities to overcome isolation, build self-reliance and stand their ground with political and economic institutions, thus shaping their own destiny and that of their descendants and the forests.

### Thinking about investment differently

For a locally controlled forest enterprise that is struggling to raise investment capital, as many other SMEs do, it may be reasonable to assume that any kind of investment will do. Money is useful wherever it comes from. However, not all investment is the same, and a mismatch between the goals of the investor and those of the enterprise can create

problems in the future. Profit-seeking investors have fairly straightforward goals that should also be shared by the enterprise; that is, make a profit. But these investors are also the most demanding, and most SMEs fail to meet their criteria.

Therefore, where investment in locally controlled forestry has taken place, it has often come from governments, donors and philanthropists, working through non-government organizations (NGOs) or state-run bodies. In some cases investment has come from the private sector under the umbrella of a Corporate Social Responsibility (CSR) scheme. The downside of these kinds of investments is that they usually aim to achieve non-business outcomes, such as social or environmental goals. That may mean they bypass essential steps needed for long-term commercial success.

With few exceptions, trading companies set up by NGOs are neither commercially successful nor efficient at meeting social and environmental goals. In the community forestry sector, unused sawmills stand rusting in the forest, the legacy of a well-meaning grant from an NGO or local government department. Gifts of equipment, or “soft” loans without conditions, compromise the underlying viability of the business. Enterprises that might otherwise have been able to achieve self-sufficiency become dependent on subsidy, and capital is misallocated to visible and easily verifiable items (e.g., sawmills), rather than the crucial, but hard-to-measure, aspects of business development, such as leadership skills and technical training.

When the non-profit sector makes soft loans in an effort to use commerce to meet their social or environmental goals, or for-profit companies set up CSR schemes in an effort to achieve a social licence for their main commercial activities, both expertise and capital are being poorly allocated. The end result is blurred boundaries and confused goals. Most crucially, mainstream investors remain on the sidelines, unconvinced and unengaged.

This is why we need to change the way we think about investment. The non-profit sector has valuable expertise in engaging with forest communities, and is intrepid enough to get involved in isolated areas. Governments have the resources to address market failures, improve the conditions for investment (e.g., through tenure reform) and reduce transaction costs. The for-profit sector has a grasp of commercial realities and links to markets, technology and capital. The challenge is to structure these different types of investment in the right way.

### An example of a challenging case

Even when investors are keen to get involved in locally controlled forestry, they are often deterred by the complexities of engaging commercially with remote communities in hard-to-reach places. For instance, in Indonesia’s Papua Province, on the western half or New Guinea island, some indigenous communities have recently been granted permits to extract limited quantities of valuable hardwood (*merbau*) from the primary forest. On paper, this may look like a business of sufficient scale, as each community group could, in theory, have annual sales of US\$ 250,000.

In practice, however, the groups have limited capacity, are isolated and are most unlikely to achieve even a fraction of these potential sales. They are having difficulties with equipment and face organizational challenges. The local government — to its credit — supports locally controlled forestry and is keen to ensure that these communities maintain local control over their enterprises, but there is a danger that outside interests may make deals to manage the extraction process in a way that does not benefit the local people. Furthermore, Indigenous People are finding that even when they deliver timber to the local city, the prices they are being offered are very low compared to prevailing market rates.

The challenge is how to channel investment to these groups so they can acquire essential capital equipment and cover running costs, while also linking them to markets, facilitating local permit and legality issues and ensuring that they build a robust asset base over time. This needs to be done in a manner that will not weaken the long-term business case or inhibit the capacity of the local people to learn by doing. The answer may lie in learning how Swedish forest cooperatives overcame similar challenges.

### Learning from Södra

Södra is one of Sweden's most successful forestry cooperatives. Owned by 51,000 members, it has annual sales of over US\$2.5 billion. It is among the world's leading pulp producers and suppliers of construction timber. Yet the cooperative was originally formed with the modest vision of improving the prices that family forest owners were getting for their timber.

The founding insight of Södra in the 1930s was that increasing skills would not be enough to substantially improve livelihoods of forest farmers. Northern long-rotation forestry required income in the present day in order to develop better practices that will yield benefits in 60 to 100 years. This required good prices from the mills, but the mills seemed to be exercising their market power to drive down prices at the farm gate. In the early years, Södra was involved in product aggregation in order to obtain better prices from the mill, in addition to giving technical advice to farmers.



As Södra grew stronger, members saw the need to move into the processing industry, for which it required capital. Today, Södra would not have any difficulty obtaining bank financing for any of its subsidiary companies. In the early years, however, it would not have been able to expand into the processing industry without substantial capital. This asset base was created by the farmers themselves, who agreed to forgo a portion of the revenue for all the timber they sold to the cooperative. This revenue was held in a capital account in the member's name and invested in the business. Södra was built by the parents and grandparents of the current members.

Although it exists to benefit its members, Södra must still operate in the world market, and it would not be sustainable if it paid prices to farmers that were too far above market rates. The Södra pulp mills are said to be firm but fair with the farmers, driving a tough bargain and expecting a high-quality product. This keeps the mills profitable and lets the farmers gain through the benefit sharing process.

### Applying the Södra model in Papua

For community forestry to be successful in Papua, it needs to be acknowledged that it will be some years before these community units are independent enterprises that can attract investment on their own merits. To cover this transition period, the communities are working with local NGOs and entrepreneurs to form a joint venture (Elson 2012b).

This joint venture would supply equipment, arrange transport and permits, and deal with sales and marketing of the timber. The community would still have control of their traditional forest area, but would delegate certain aspects of commercial activities to a private company. This would enable them to reduce risk, improve stability of the enterprise, achieve a steady income and over time create a good reputation. The company would take on the riskier aspects of the business, increase the scale of the initiative and improve negotiating strength. Communities could concentrate on what they know about the forest landscape and work to organize their community around a common purpose.

The strength of this concept is the fact that it takes some of the risk out of investment in the capital equipment. The business units develop specific expertise that would be hard for individual community forest units to develop on their own. For instance, the leasing and logistics unit will have expertise in maintaining equipment, while the trading unit will develop strong market skills. The business will likely need to look initially to donors and impact investors (those who seek to create positive social returns) for capital investment, and grants will be needed to cover some of the transaction costs and the capacity building. But over time, the company will be able to obtain mainstream financing.

### Critical success factors

Family foresters in 1930s Sweden and today's indigenous communities in Papua cannot be compared directly. But although the contexts are very different, the constraints are similar. Even today, it would be unlikely that a single farmer in Sweden, or a small group of farmers, could leverage their income from timber to raise investment capital to buy their own equipment. They would face the same issues of scale and capacity that are faced by communities in Papua. Working together and pooling resources to invest in a business owned by a cooperative is the most sensible thing to do in such circumstances.

There are various ingredients for success in any enterprise (Elson 2012a), of which these three are most pertinent in this case:

- the business is a separate entity;
- a benefit-sharing mechanism is in place; and
- financial sustainability is possible.

### *The business is a separate entity*

There needs to be clear delineation between managers and local owners, where such roles may often overlap in practice. Local rights-holders may have representation as investors (either as direct shareholders or through their membership in a cooperative), but this does not confer the right to influence the day-to-day running of the business. Although Södra, as a cooperative, may encourage democratic participation, the business itself may not be particularly democratic.

All parties must consider the business to be a separate entity that stands apart from its directors and shareholders. In some jurisdictions a company is in fact a discrete legal entity and the embodiment of the agreed rights and obligations of all parties. The company's interests cannot be subordinate to any group of stakeholders and the benefits should be distributed according to an agreed formula. This is the basic position when negotiating benefit sharing: any act that compromises the sustainability of the business cannot be permitted, even if all parties agree to it.

### *Benefit-sharing mechanism*

Locally controlled forestry is a means to improve the livelihoods of local people and alleviate poverty. This is one of the main reasons that rights-holders advocate for stronger tenure and wish to promote investment in locally controlled forestry.

In order to build a business over the long term, however, rights holders also need to see themselves as long-term investors. Like the members of Södra, they must forego consumption today in order to build up something bigger for tomorrow.

In some respects, this concept of financial sustainability is analogous to environmental sustainability. Just as sustainable forest management demands some sacrifice of short-term revenue in order to secure a long-term flow of goods and services, sustainable financial management also requires self-restraint. The Swedish farmers of the 1930s were not especially rich — indeed, there was much poverty in rural Sweden at the time — but they saw the long-term benefits of deferring some of their income in order to secure future assets. In order to do this they had to have trust in the cooperative, which they buttressed with their own role as overseers of the management team. Even where most commercial activities are delegated to shared organizations, such as Södra, locally controlled forestry requires active involvement in all the institutions, and ongoing engagement with local and national political issues.

### *Financial sustainability*

At the heart of the model exemplified by Södra is the recognition that the task is to build a viable business rooted in commercial reality. While grants and philanthropy can improve external conditions (such as tenure), and develop favourable internal conditions (such as management capacity), these are just the stepping-stones to becoming a fully commercial business. Many cooperatives have demonstrated that there is no contradiction in being community-owned and yet resolutely commercial.

Building on these core principles and applying them in Papua — which is a challenging context for development interventions — will require a layered investment approach that includes both grant-funded enabling investments and more conventional asset investment. The aim is to build a sustainable business, not just obtain short-term rents or income from labour. Sustainability is the goal, not only in the environmental sense — although of course that is crucial for a locally controlled forestry business to thrive in the long term — but in the financial sense. To survive, a business must get many things right; the most fundamental insight is to focus on the market.

### Conclusion

Forests can be managed so they yield sustainable economic and financial returns. In addition, almost any individual or group of people possessing imagination, enthusiasm and access to expertise can build a successful forest enterprise. The challenge is to interpret local conditions in a manner that reconciles the goal of strengthening local control while building a viable business that is attractive to investors. This means including local people as investors — not just participants — so that all parties can achieve their aim of creating sustainable financial and environmental value.

### Endnote

1. Data comes from International Family Forest Alliance: [www.familyforestry.net](http://www.familyforestry.net).

### References

Elson, D. 2012a. *An Investment Guide to Unlocking the Value of Locally Controlled Forestry*. London: Growing Forest Partnerships.

Elson, D. 2012b. PT Rio Grime Community Forestry Leasing and Marketing Company: Business Proposal (Draft v.1.1), Jayapura, Indonesia.