



Forest Bonds—Understanding How Debt and Forest Conservation Are One

A Commentary on *Unlocking Forest Bonds: A High-Level Workshop on Innovative Finance for Tropical Forests* and *Understanding Forest Bonds: A Guide to Raising Up-Front Finance for Tropical Forests*

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Unlocking Forest Bonds: A High Level Workshop on Innovative Finance for Tropical Forests and *Understanding Forest Bonds: A Guide to Raising Up-Front Finance for Tropical Forests* are two reports that provide a succinct, easily understood, and persuasive case for creating an independent class of bonds that would focus on tropical forest preservation. The reports are a great summary read for conservation finance professionals or those who are interested in raising private capital for conservation purposes. The reader may come away with a series of “what ifs” but therein is the value. If forest bonds can be made to work, implementation can be structured in many different ways to address the particular circumstances of individual transactions.

Unlocking Forest Bonds

Unlocking Forest Bonds is the result of a workshop in which public, finance, academic, and business leaders held discussions to determine the necessary conditions under which bonds could become a useful financing mechanism in the effort to conserve tropical forests. The report is organized in five sections to address the following significant topics: buy-side perspectives, sell-side perspectives, risk mitigation, forest country perspectives and country donor perspectives. Each section begins with key points and contains helpful figures and graphics to better understand those points.

The report does a good job of outlining how bonds can best be used to raise large sums of private capital to preserve forests. Of equal importance, it helps to explain what will be expected from investors in exchange for their loans and what will be expected from countries that are the recipients of these funds. The takeaway is that numerous compromises are inherent in borrowing money for forest preservation, and it is important for all parties who enter into such relationships to have a very clear understanding of the terms.

As one who works in the area of conservation debt, I find that perhaps the report’s most important information surrounds the discussion of risk. As the authors point out “risk

mitigation is paramount.” By *risk*, the authors mean commercial risk, market risk, and political risk. Assigning and managing the risks associated with these factors in the case of default often makes or breaks a debt transaction. The report identifies an array of risk management mechanisms and how they can be used to help lenders and borrowers achieve the comfort they need to move forward with a debt transaction.

Understanding Forest Bonds

Understanding Forest Bonds, published by the Global Canopy Programme, is focused on the nuts and bolts associated with bond financing. The report makes the case for using bonds to finance forest preservation and then addresses the question of who would invest in these bonds; outlines different frameworks for generating cash that is essential for debt service; outlines various institutional arrangements and delivery mechanisms that might be used; and describes different forest bond structures. The report closes with discussions about which countries might best take advantage of forest bonds and how to make a forest bond program work. A glossary included at the end of the report is a valuable resource for those who are new to bond discussions and unfamiliar with the highly specialized language associated with debt financing.

Addressing the Issues

The report highlights a number of important issues associated with financing forest acquisitions with bond proceeds.

Tried and True Financing. Bond programs allow interested parties to tap into a well-established private capital market to raise large levels of capital necessary to preserve forests at scale. Successfully structuring a bond and servicing its debt over time will attract more capital and larger sums than will federal appropriations and/or philanthropic mechanisms.

Financing Flexibility. The great thing about debt financing is its flexibility. Individual transactions can be structured in many different ways and leveraged with different sources of equity and public/philanthropic capital to match a project’s biological and cash-flow characteristics, lender return expectations, risk and timing requirements, and borrowers’ sustainability objectives among other objectives. While the options are numerous, the report provides a summary of six structures that could be used by lenders and borrowers to structure bond financing.

Structural Flexibility. Bonds can be structured flexibly to address individual country capabilities. Said differently, some countries’ investment-grade rating would be conducive

to government-backed bonds whereas other countries' lower-than-investment-grade ratings would be more conducive to a commitment-based bond structure.

Some Closing Thoughts

These reports are excellent primers on bonds and the ways in which they can be structured to fund large-scale forest conservation. Yet there are a number of difficult issues that our firm has experienced in trying to use debt to finance forest conservation. Perhaps some of these issues could serve as the basis for a follow-up study and to further build support for a forest bond program.

To begin with, federal and local institutions are not in a place right now where they can or want to fund or guarantee what they see as new and potentially risky forest conservation transactions. Moreover, the learning curve is steep for anyone who wants a full understanding of the forest asset class. Finally, though an international effort is afoot to create ecosystem service markets, they are generally not bankable. An oversimplified conclusion is that forest bonds are not viable because investors are not confident that projected cash flows under a conservation regime will service debt associated with a commercial purchase price.

However, and in addition to the reports' recommendations on this topic, there may be ways around this dilemma. First, an appropriate level of sustainable harvest should be assumed. Meaning that bonds and debt are probably not conducive to properties for which no harvest is contemplated. Second, federal and local governments can play an important role by authorizing municipal bond structures in a way that lowers the cost-of-capital in exchange for conservation commitments; for example, by structuring a bond so that a lender country will lower its capital cost by 100 basis point in exchange for the borrower prohibiting fragmentation or accepting limits on certain harvest activities. Third, forest bond users might think about how forest ownership and governance can be structured in a way that provides comfort to investors, forested countries, and local citizens. One way to do this is to create private nonprofit forestry companies that have economic objectives in terms of debt service but that also maintain agreed-upon levels of forest conservation. Fourth, to the extent that bond terms can be extended to 20, 30, or ideally 40 years, significant pressure will be taken off forests to produce returns at the expense of conservation in the short term or in difficult markets.

Finally—and this is more philosophical than substantive—when looking at bonds and associated debt service, it is important to look at the actual forest and not just individual trees. Forest bonds will require debt service, and debt service may require harvesting trees at a rate that some view as unacceptable; however, harvesting trees at accelerated rates would be temporary, and once that debt was serviced, conservation would grow over time

and any ongoing proceeds could be funneled back to local communities. In the authors' viewpoint and mine as well, the alternative actions (or inaction) lead to more fragmentation and more deforestation that will be difficult to manage. The great thing about forests and forestry is that we can manage at various intensities to achieve different goals. When one lines that concept up with bond financing, it is likely that large sums can be raised to reach various environmental, social, and economic objectives.

I share the authors' perspective that tapping into private capital bond markets can go a very long way in helping to preserve forests. Time is too short, traditional public and philanthropic financing programs are too limited and the scale is so large that failure to do so will certainly mean that conservation at a meaningful scale will be difficult if not impossible to achieve.

Biography

Mr. Tuchmann is President of US Forest Capital, LLC, an advisory services company based in Portland, Oregon. US Forest Capital assists clients in identifying, managing, and financing natural resource transactions; creating and improving governance structures; and resolving public policy and communication challenges. In this role, Mr. Tuchmann helped to raise \$240 million in conservation funding that conserved 110,000 acres of private working forestland.

In his previous role as Western Director and Special Assistant to the U.S. Secretary of Agriculture, Mr. Tuchmann successfully directed negotiations and implementation of the \$480 million Headwaters Forest Agreement and arranged President Clinton's Forum, resulting in a \$50 million plan for Lake Tahoe. Before joining the Department of Agriculture, Mr. Tuchmann served as the Director of the U.S. Office of Forestry and Economic Development.

Mr. Tuchmann is a forestry graduate of Northern Arizona University and earned a Masters degree in natural resource policy from Pennsylvania State University. He has written and spoken widely on natural resource issues. He served on the Society of American Foresters' Committee on Forest Policy and as an adjunct professor at the Northwestern School of Law at Lewis and Clark College. Mr. Tuchmann currently serves on the boards of Sustainable Northwest and the Forest Park Conservancy. He can be reached at <mailto:tuchmann@usforestcapital.com>.