Commercial investment in forests and sustainable land use - recommendations for companies and funds

On behalf of FMO

July 2023

TERRANOMICS

Contents

For further information on this project, please contact chris.knight@terranomics.org or c.broekman@fmo.nl.

The views expressed in this report are those of the Terranomics team. They do not necessarily represent those of FMO or the organisations referred to within.

Acronyms

DD	Due diligence
ESG	Environmental, Social and Governance
FMO	Netherlands Development Finance Company
FSLU	Forests and sustainable land use
LP	Limited partner
MFF	Mobilising Finance for Forests
NBS	Nature-based solutions
NGO	Non-governmental agency
SFDR	Sustainable Finance Disclosure Regulation

Executive summary

Despite the environmental and social benefits of forestry and sustainable land use projects, investors want a clear route to returns, within reasonable timeframes, and confidence in management teams.

Context and summary
The effects of climate change and the breakdown of nature are observed more and more frequently and with greater magnitude. The land use sector (including forestry and agriculture) is a major source of greenhouse gas emissions, but also a major opportunity for reversing this trend through carbon sequestration and habitat restoration. Yet, investment in this sector is far below what is needed to meet global climate and biodiversity goals. It is often limited to public or non-commercial actors that prioritise impact, but may lack the large pools of capital needed to drive significant change.

In the first half of 2023, Terranomics conducted desk-based analyses and 40 stakeholder interviews to develop practical guidance on attracting commercial investment ('investors'[1]) into the forests and sustainable land use (FSLU) sector. The recommendations primarily target FSLU-specific fund managers ('funds') and company executives ('companies') within (or considered for) the Mobilising Finance for Forests (MFF) portfolio. The project identified the priority barriers to commercial investment in this space and developed recommendations to address these. Ten recommendations were shortlisted based on their value to commercial investors and the likelihood of them being actionable in the near term. These barriers and recommendations are vitally important to consider in the still-nascent and niche FSLU sector. Some are well-known yet are not sufficiently acted upon, while others are as of yet unknown by many funds or companies. A long list of all barriers and recommendations can be found in Appendix document.

Barriers to commercial investment in FSLU

- These include the mismatch in tenor preferences between investors and companies, the lack of strong fund and company track records in FSLU, weak investment fundamentals and low risk-adjusted returns, and liquidity challenges.
- There is general alignment between companies, funds and investors on the top barriers to attracting investment in FSLU, but unsurprisingly, investors tend to prioritize factors directly affecting their investment returns whereas companies and funds are focused on a broader set of considerations such as impact and stakeholder relations.

Recommendations for companies and funds

- Companies – share detailed business plans and financial models with comprehensive disclosures on risks; secure local government, NGO and community support for projects; make investor due diligence easier through transparency and proactive information sharing.
- Funds – tailor fund vehicles to Limited Partners (LPs) preferences and their target geographies; build stronger pipelines through NGO partnerships; align with sustainable finance regulations.
- Both groups - build teams with complementary skill sets and deep experience; diversify income streams to enhance risk-adjusted returns; target financial and carbon-linked returns; provide investor-friendly liquidity options.

Some recommendations will be more or less viable, depending on whether a company or fund is at an early stage or is a mature entity. Recommendations are described in more detail in the subsequent pages of this report. An Appendices document covers a longer list of barriers and recommendations for these.

1 Non-concessional equity or debt finance provided by mainstream financial institutions

Executive summary

Figure 1: Priority barriers and shortlisted recommendations targeted at these

	Structural barriers		Management barriers		Financial barriers			Implementation barriers	
Barrier theme	Institutional fit	Country risk	Team quality	Strategy and planning	Investment fundamentals	Investment structures	Costs	ESG risk, impact management	Carbon aspects
Specific barriers cited	• 'Fit' - FSLU is a novel asset class • Regulatory barriers restrict allocations	• Country and jurisdictional level risks • Political uncertainties • Currency risk (companies)*	• Lack of proven and joint track record • Competency gaps (finance, technical)	• Weak business plans (companies) • Poorly developed financial modelling (companies) • Poor data presentation (companies)	• Low risk-adjusted returns	• Liquidity challenges • Tenor mismatch • Misalignment with equity or debt instrument needs (companies) • Lack of truly concessional finance	• High fund management fees (funds) • Due diligence (DD) costs (companies)	• Inadequate impact metrics and data • Lack of 'useable' external standards • Impacts on local communities including land tenure and rights (companies)	• Market uncertainties and pricing challenges

Shortlisted recommendations – grouped under the barrier theme they most directly relate to.

Institutional fit	Country risk	Team quality	Strategy and planning	Investment fundamentals	Investment structures	Costs	ESG risk, impact management	Carbon aspects
Funds • Align with the EU Sustainable Finance Disclosure Regulation	**Funds** • Tailor fund vehicle to Limited Partners and geographies	**Funds** • NGO pipeline partnerships **Both** • Complementary skill sets, experience, portfolio management systems	**Companies** • Provide detailed business plans, models, exit paths, fully disclose risks	**Both** • Diversify income streams to enhance risk-adjusted returns	**Both** • Offer investor-friendly liquidity options	**Companies** • Offer support for due diligence processes	**Companies** • Secure local government, NGO, and community support	**Both** • Target both financial and carbon-linked returns

*Barriers are relevant to both companies and funds, unless indicated in brackets. Not all barriers will be applicable to both debt and equity. This is not an exhaustive list and an Appendices document covers a longer list of barriers and recommendations for these.

Introduction

Climate change and biodiversity loss is an increasingly urgent global issue. FSLU represents a significant tool to help reverse this current trend. However, the sector currently lacks the necessary investment, particularly from commercial actors, to achieve this action. The aim of this study was to provide practical guidance to funds and companies to better attract commercial investment into FSLU. In the context of this study, commercial investors include pension funds, insurers, banks, and other mainstream capital providers.

The analysis explored factors that attract and barriers that deter, commercial investors ('investors'). It also reviewed gaps in understanding between companies, funds and investors, and how willingness to invest might differ between FSLU project types, or between investor types. A set of recommendations were developed, targeted at the most prominent barriers. Recommendations are focused on companies and FSLU-focused funds and are not universally applicable – some may be more viable and pertinent for early-stage or mature funds or companies.

Methodology

Literature review	Review of 19 relevant documents. A summary of the literature review can be found in the Appendices.
Expert interviews	Interviews with 40 expert organisations, including investors, funds and companies, varying in their exposure to FSLU.
Case study	Interviews with the Althelia Climate Fund* to validate the learning points from the literature review and interviews.

Relevant stakeholders to this study

Commercial investors ('investors') - asset seeking, often with large pools of capital. May invest in FSLU-sector funds and companies (or projects). Includes pension funds, insurers, and commercial banks.

FSLU-focused fund managers ('funds') – seek capital from investors. Some funds are both asset and capital-seeking, but for the purposes of this study, we sought their perspectives on barriers when fundraising (capital-seeking).

Company executive ('companies') - seek capital from investors, or from funds managers working on behalf of investors.

Methodology for barrier identification, selection and ranking

Investment barriers were identified through 40 interviews with investors, companies and specialists in this field. Barriers were ranked according to the number of interviewees that mentioned a barrier. In addition to an overall ranking, we also ranked barriers based on the frequency of mention by investors, only. For this final report, our focus is on the priority barriers from the perspective of investors.

For a detailed list of the full barrier rankings and more detail on the barriers themselves, please refer to the Appendices.

Limitations

Literature review - time constraints affected the number of documents that could be reviewed. This also meant the scope of the literature review could not extend to specific factors such as country or asset class, but rather FSLU more broadly.

Expert interviews - interviewee time constraints meant not all questions were posed equally across all interviews. Leading questions may have influenced barriers cited by interviewees, though most were unprompted.

*The Althelia Climate Fund (launched in 2013) was chosen as a case study by FMO as it was considered to be a fund in the FSLU sector which has managed to mobilize private capital.

Findings – barriers to commercial investment

As shown in Figure 2, the taxonomy used in this study categorizes identified barriers into four distinct categories, each with specific themes relating the recommendations developed.

Figure 2. Framework for considering investment barriers

	Structural barriers		Management barriers		Financial barriers			Implementation barriers	
Barrier theme	Institutional fit	Country risk	Team quality	Strategy and planning	Investment fundamentals	Investment structures	Costs	ESG risk, impact management	Carbon aspects
Specific barriers cited	• 'Fit' - FSLU is a novel asset class • Regulatory barriers restrict allocations	• Country and jurisdictional level risks • Political uncertainties • Currency risk (companies)	• Lack of proven and joint track record • Competency gaps (finance, technical)	• Weak business plans (companies) • Poorly developed financial modelling (companies) • Poor data presentation (companies)	• Low risk-adjusted returns	• Liquidity challenges • Tenor mismatch • Misalignment with equity or debt instrument needs (companies) • Lack of concessional finance	• High fund management fees (funds) • Due diligence costs (companies)	• Inadequate impact metrics and data • Lack of 'useable' external standards • Impacts on local communities including land tenure and rights (companies)	• Market uncertainties and pricing challenges

Investor, fund and company alignment on perceived barriers

Table 1 opposite gives a snapshot of the most important barriers to investors. Page 7 describes a longer list of the top 10 most important barriers to investors.

Generally there was significant alignment between investors and companies and funds on the barriers they considered to be important.

However, notable exceptions were **due diligence costs, currency risks, benefit-sharing obligations and weak credit profiles**. These four were important to investors, but funds and companies gave them less importance. This is one example of potential blind spots where funds and companies do not have full awareness of what investors consider the most important barriers to investing.

Table 1. Most important barriers to investors	Barrier category	Barrier theme
1st - Low risk-adjusted returns	Financial	Investment fundamentals
2nd - Lack of proven and joint track record	Management	Team quality
2nd - Competency gaps (finance, technical)	Management	Team quality
2nd - Tenor mismatch (high capital expenditure, long dated return profiles)	Financial	Investment structures
2nd - Liquidity challenges	Financial	Investment structures

Findings – barriers to commercial investment

The recommendations are focused on barriers considered most important to commercial investors. Those barriers were generally acknowledged by the funds and companies we consulted. However, there were exceptions. Below we highlight the top five barriers recognised by all groups consulted, and four barriers which were less well acknowledged.

The most important barriers to investors are generally recognised by funds and companies…

Low risk-adjusted returns were the top barrier for investors. Investors view FSLU projects as having low internal rate of returns (IRRs) and risk-adjusted returns compared to other asset classes. At a fund level this is less of an issue as funds adopt a portfolio approach to improve diversity and reduce risk.

Investors also consider **lack of proven and joint track record** and established projects as a key barrier, particularly in regenerative agriculture, mixed-species and native forestry. Inability of funds to demonstrate previously executed deals and experience of full investment cycles is a significant barrier.

There is a **competency gap** within companies and funds, both in terms of financial expertise and technical knowledge related to FSLU investments. Some key competency gaps for funds/companies mentioned by interviewees related to financial planning, reporting, and modelling.

There is frequently **tenor mismatch** between investors and funds or companies. Many FSLU projects have long investment horizons, while traditional financial instruments have shorter tenors. This creates barriers in securing financing that matches the lifespan of the project and the realization of its intended outcomes.

Investors experience significant **liquidity challenges** in FSLU investments. Investors broadly want assurance that they can exit a fund or project at a desired point. Investors will take liquidity into consideration and generally advocate for greater liquidity to increase the attractiveness of investments.

However, companies and funds often miss other barriers important to investors…

The barriers below received less discussion or attention from companies and funds than from investors. This suggests that they could be better addressed by funds and companies. The recommendations address some of these where relevant.

Due diligence costs are higher in FSLU compared with other sectors. This barrier is compounded by the fact that some investment analysts are not as familiar with FSLU as with other sectors. This results not only in added costs, but increased uneasiness among investors considering FSLU projects.

There is a common mismatch between investors and project developers on **benefit sharing obligations**. Investors do not appreciate the need for benefit sharing with communities, and they are deterred by the perceived reduction in IRR this results in.

Weak credit profiles or lack of collateral is a barrier for more debt-focused investors, especially commercial banks. Investors can view FSLU businesses as having 'project finance' models with challenging cash flows.

Currency risk, and more specifically foreign exchange risk, was identified as a significant concern for some investors when investing in emerging markets. This is an issue inherent to any investment in emerging markets and is not unique to FSLU.

Findings – recommendations for companies and/or funds

We provide a set of ten recommendations for companies and funds. The aim to increase the attractiveness of a company, project or fund to commercial investors.

Three recommendations are applicable to companies, three to funds, and four to both groups. Each group therefore has up to seven recommendations they can consider implementing.

Recommendations vary in the timescale of implementation. Several are achievable in the short term (e.g. less than two years) and without significant financial or strategic implications. The recommendations cover all the barrier themes identified in the study. This ensures that all funds and companies have options to address the barriers most relevant to them.

On the following pages each of these recommendations is described in more detail. They are linked to the specific barriers to commercial investment in forests and sustainable land use which they address (the 'why'). Recommendations can be attempted in any order. However, we have tried to present them logically beginning with activities related to team building, planning and structuring, before moving on to implementation and areas such as external reporting.

Seven further recommendations can be found in the separate Appendices accompanying this document.

Actionable recommendations for companies, FSLU-focused funds, and both groups
(in brackets is the location of each recommendation in the full report)

Companies
1. Provide detailed business plans, models, exit paths, fully disclose risks (page 9)
2. Secure local government, NGO and community support (page 9)
3. Offer support for due diligence processes (page 10)

Funds
1. Tailor fund vehicle to Limited Partners and geographies (page 10)
2. Align with the Sustainable Finance Disclosure Regulation (page 11)
3. Build NGO pipeline partnerships (page 11)

Recommendations jointly applicable to both groups
1. Complementary skill sets, experience, portfolio management systems (page 12)
2. Diversify income streams to enhance returns (page 12)
3. Target financial and carbon-linked returns (page 13)
4. Offer investor-friendly liquidity options (page 13)

Recommendations applicable to companies

Provide detailed business plans, models, exit paths, fully disclose risks

Barriers addressed: Weak business plans; poorly developed financial modelling; poor data presentation; lack of concessional finance

Theme: Strategy and planning

"We need to see [strong] financial modelling. Only then will it become clear what the business model and cash flow is, and whether there is an existing market." [Investor]

Why – investors report weaknesses in business plans, which rule out the vast majority of projects at first pass. Companies can place too much emphasis on environmental, social and governance (ESG) impact, neglecting commercial factors influencing risk and return. Very few companies subsequently have financial models acceptable to investors. This may link to a general lack of data available to investors, something frequently discussed in relevant literature (see the Appendix). However, the broad investor view was that the way in which the data is presented is equally as important as (if not more so than) their availability. Lastly, concessional finance providers want confidence their funds will support, not hinder, commercial investment over time.

Action – as minimum the following should be included in investor approaches:

- A project overview and detailed business plan, disclosing all risks facing project implementation, particularly those relating to markets and local ESG factors.
- Detailed financial models based on best practice and sensible forecasts, a cautious approach to asset valuations, and a credible route to scale with exit path options. Financial models incorporating concessional investments should also outline a route to commercial viability, considering frameworks such as the Blended Finance Principles.

Ideally, third party legal and tax opinions, and standard term sheets will also be supplied to investors.

Viability and value – strong project teams should have developed most of this thinking and material during their formation. Depending on prior work, therefore, this can be achieved within a three to nine-month window at relatively low cost. Documenting this in a form which is investor friendly and with third-party validation, may incur consultancy fees respectively. For example, internationally recognised forest valuation experts may incur more fees but could confer greater credibility.

Sources of further guidance and examples

- Example best practice guidance on financial models can be viewed here and here.
- Tools to guide companies are available here (section 5) and here (pages 40-85)

Secure local government, NGO, and community support

Barriers addressed: Impacts on local communities including land tenure and rights; country risk; political uncertainties; lack of 'useable' external standards.

Themes: ESG risk, impact management; Country risk

"We need projects to create the right incentives for local communities – we need to get them involved in these projects." [Investor]

Why – potential impacts on local communities are a key barrier for investors who wish to avoid reputational risk. This risk is compounded given a lack of usable external standards and impact data which might otherwise alleviate these concerns. Good relationships with NGOs and communities are crucial for business stability. Putting these in place will help companies to maximise the value that benefit-sharing arrangements add in improving risk-adjusted returns, and to explain these to investors.

Action – have in place good relationships and formal MoUs with regional and national level government entities. These should be supported by a range of local staff and teams with long experience working within or close to the government that will survive disruption caused by electoral processes. In some cases it may also be possible to work with local operators and contractors that have long-standing local relationships.

More broadly, professionalizing a company's operations and its policies and processes for fostering local networks and relationships will help to address the barriers above.

Viability and value – if longstanding government relationships are not in place, it may be possible to recruit individuals with those credentials to act as advisors to, or employees of, the project or company. Support is valuable in reducing investor concerns over local risks. With concerted efforts, this can be achieved within 1-2 years depending on existing staff, relationships and prior efforts.

Sources of further guidance and examples

- See pages 104-113 of the Little Book of Sustainable Landscapes
- WCS Seima REDD+ project is often cited as a good practice case study in community benefit-sharing.

Recommendations applicable to companies

Offer support for due diligence processes

Barriers addressed: Due diligence costs; high management fees

Theme: Costs

"If they are sub-scale, companies should focus on making the due diligence as smooth as possible, have structures that do not require a lot of work or costs for the investor." [Fund]

Why - due diligence (DD) is expensive and time-consuming for investors. Even those with a strong focus on impact and ESG may reject companies because DD costs are too high relative to the size of the investment. Projects with lower perceived DD burdens are thus preferential. This barrier is compounded when companies use bespoke or unique information-sharing processes. Instead there is a need for standardised DD support which investors will recognise.

Action – alleviate the DD burden by adopting practices that are recognised and appreciated by investors, such as:

- Virtual data rooms (secure online repositories to share information during DD) to maximise transparency and information flow
- External verification for financially material projections, valuations and other consequential disclosures
- Integration of independent studies (public domain or commissioned) to verify companies' own views on market aspects
- Detailed risk registers and risk modelling outputs, best practices for corporate governance
- The use of credible banks, law firms, and accountants whose own client acceptance requirements may reassure investors
- Information on the management team and key stakeholders (particularly those with political ties)

Viability and value – these are valuable both in helping attract investors and in accelerating the fundraising process. Generally, the actions above may be achievable without significant costs but some aspects may require 6-12 months to achieve.

Sources of further guidance and examples

- See this table for guidance on creating a risk register for projects to show to prospective investors (p.82) and Table 11 in this.

Recommendations applicable to funds

Tailor fund vehicle to Limited Partners and geographies

Barriers addressed: Country and jurisdictional level risks; political uncertainties; currency risk

Theme: Country risk

"Develop a fundraising strategy that considers blending options and the optimal sequencing of funding rounds. Funds need to think in a linear and strategic manner" [Investor]

Why - country risk is a major barrier for most large investors considering FSLU investments. Certain investors may have blanket exclusions for certain countries or jurisdictions. However, some investors can consider higher-risk jurisdictions if political uncertainty, social unrest and ease of doing business risks are limited. Investor circumstances will also influence their preferred investment vehicles. These include their investment horizons and liquidity needs, domicile and tax considerations, and regulatory burden they may be comfortable with.

Action – engage potential investors early in a fund's design, and be responsive to their feedback during the fundraising process to ascertain those strategies and vehicles which will 'fit' better with them. Groups such as consultants, impact investor networks, ICFA and the Forest Investor Club may be able to facilitate access to some investors for early-stage conversations and informal dialogue.

Review target countries and investment strategy (markets, income drivers, crop/product/asset selection) as these are key factors which will impact the appetite of investors. This recommendation should be part of a continual effort of marketing, communication and engagement with investors on an ongoing basis.

Viability and value - ultimately this is crucial to fundraising success but it depends on the fund's capacity. This will be easier for fund teams with prior experience raising capital, working in the target countries, and with good networks. Done early this can reduce effort later in a fundraising process. As this action requires funds to consider strategy shifts and gain buy-in from internal/external parties.

Sources of further guidance and examples

- See Designing an impact investment fund and the Althelia Climate Fund (which considered investor needs and fund structures mainstream investors would understand) and case study.

Recommendations applicable to funds

Align with the Sustainable Finance Disclosure Regulation (SFDR)

Barriers addressed: 'Fit' - FSLU is a novel asset class; regulatory barriers restrict allocations

Theme: Institutional fit

"Article 9 (of the SFDR) is key for investors. We have partnered with an institutional manager for an Article 9 fund which led to other investors and insurers subscribing as they see Article 9 alignment as key." [Investor]

Why - large financial institutions struggle to fit FSLU/NBS strategies into their existing asset and product classes and internal business structures. This owes partially to FSLU being a novel asset class compared with other 'green' sectors, especially for large private investors. Regulatory barriers (for example, Basel III regulations) can also restrict their involvement in FSLU. The European Commission's SFDR regulation provides FIs with a 'labelling' system which allows them to more easily 'process' this otherwise novel asset class, and integrate it within existing products and market offerings. In short, funds aligned with Article 8 or 9 may find it easier to engage with a larger pool of private investors.

Action – align processes with SFDR and improve understanding of the Regulation. In order to access European investors, and potentially other investors, the SFDR requires funds and asset managers to make disclosures in fund prospectuses, websites and other materials in relation to so-called 'dark green funds' or Article 9 funds. An Article 9 fund is "a Fund that has sustainable investment as its objective or a reduction in carbon emissions as its objective". FSLU funds which have strong knowledge and processes of Article 9 can effectively engage with investors looking to include deep green investments within their portfolios. Other established and emerging frameworks may be considered for the same aims, including the SBTi or TNFD frameworks, for example.

Viability and value – funds can align with SFDR by understanding the requirements, integrating sustainability considerations into investment processes, and implementing robust reporting mechanisms. Leveraging existing frameworks and engaging experts can streamline the alignment process and enhance appeal to EU-based institutional investors, whether looking at assets within, or outside the EU. All this takes time to implement, but overall, aligning with SFDR offers opportunities to access capital from investors seeking sustainable assets.

Sources of further guidance and examples

- Free SFDR toolkit developed by BII
- Dasos Capital

Build NGO pipeline partnerships

Barriers addressed: Lack of proven and joint track record; competency gaps (finance, technical)

Theme: Team quality

"You want a team with the experience executing transactions, partnered with local consultants and NGOs who are experts in those regions and sectors." [Investor]

Why - lack of supply of bankable projects with strong business models, teams and track records is a recognised barrier which fund teams alone cannot solve. Funds experienced with timberland investments may have stronger track records in some countries and have endured full investment cycles. However, sourcing quality deals in higher risk countries, or less mainstream sectors such as regenerative agriculture, mixed-species or native forestry can be challenging. The presence of an international NGO as a fund implementation partner may give some investors reassurance on pipeline and scale-up capacity.

Action – link fund origination processes with the sector-specific initiatives of entities such as WWF, CI, and TNC. This can help funds access a range of project teams seeking capital. NGOs can be an untapped source of early to late-stage investment project concepts. International NGOs have multiple country offices and teams, partnerships with multinational corporates in the forest and food value chains, and relationships with governments and local communities. As well as NGOs, funds can build partnerships with local operators and contractors, necessary for land use projects.

Viability and value – time and effort is required to develop NGO MoUs and to work with their local project/company contacts to develop investment concepts. Nonetheless, this model has worked successfully for several funds. Informal MoUs can be developed relatively quickly and at a low cost, assuming good relationships are already in place with the NGOs.

Sources of further guidance and examples

- MoMo4Climate
- Conservation International and Goldman Sachs Restore Fund

Recommendations jointly applicable to both companies and funds

Build complementary skill sets, experience, portfolio management systems

Barriers addressed: Lack of proven and joint track record; competency gaps

Theme: Team quality

"A crucial factor is having a dedicated team of experts. The composition of the team is of utmost importance. What is needed are individuals who truly possess a deep understanding of the subject matter." [Investor]

Why - with FSLU being a new field, institutional investors perceive higher risk in teams without a track record. Often new funds will experience this barrier more acutely. Even if an adept team's experience does not come from FSLU, this still provides investors with confidence. Funds should prioritise demonstrating a track record in delivering returns, while companies should prioritise having a strong and balanced mix of expertise within their team. Some investors value a combination of seasoned professionals and junior specialists for diverse perspectives, with at least 12-18 months joint working history. Portfolio management systems (for ESG risk management) can be used to manage risks and gather credible impact data, and allay some concerns over track record.

Action – hire staff (internal) or consultants (external) or train existing staff to fill experience. Aim for:

- Several years (ideally decades) successful track record delivering exits to investors, through at least one investment/market cycle
- Financial management skills, (relevant) market/product technical skills and ESG technical skills
- A level of carbon expertise (project implementation or carbon markets)
- Country/regional experience and networks (or access to those)
- Portfolio management systems – these vary in sophistication and some funds have developed their own tailored systems.

Viability and value – external hires to fill team gaps may increase operating costs. However, the time and money invested in this action will be key to unlocking investor interest.

Sources of further guidance and examples

- ICFA may be able to provide young funds with mentors who can help with team building.
- Althelia's co-founders were involved in numerous deals prior to the fund set-up (see Appendices) and developed a bespoke portfolio management system.
- UNEP has case studies of its work with the AGRI3 Fund and the Responsible Commodities Facility (RCF) to develop their impact and ESG frameworks.

Diversify income streams to enhance risk-adjusted returns

Barrier addressed: Low risk-adjusted returns

Theme: Investment fundamentals

"Return is important – even with first loss, equity and debt, the returns can be low. The returns from FSLU funds have not been great for the investors to date." [Fund]

Why - low risk-adjusted returns was the most frequently mentioned barrier by investors in interviews. Even for timber concessions, likely returns of 4-5% do not match investor expectations of 10-12%. At a fund level this is less of an issue as funds adopt a portfolio approach to improve diversity and reduce risk. Investors are comfortable with low returns if risk levels are commensurate and there is a clear exit path. By diversifying the sources and timings of cash flows into a project, investors are able to calculate better risk-return profiles. Investors acknowledged this is easier across a portfolio than for an individual company or project, but larger 'landscape approach' projects might sometimes achieve this.

Action – design projects and portfolios with diverse crop and income streams. For example, construction timber, pulp and fuelwood, voluntary carbon credits, permanent crops and agroforestry.

Viability and value – this action may require a strategic shift in thinking and would not be rapid to implement. Hence it should be considered a medium-term goal. Several investors noted this would be a key differentiator in their evaluations. Important to note, however, is the value of specialism within a company or fund. Diversifying income streams should not be at the expense of FSLU expertise. Investors can already diversify by investing in different specialist funds, and may prefer funds or companies that clearly demonstrate expertise and competency in an area.

Sources of further guidance and examples

- Commonland's 4 Returns Frameworks, Landscape Finance Lab provide guidance on developing landscape-level multi-crop investment programmes.
- TerraTai (launched in 2023) and Eco Enterprises (first fund launched in 1998) fund spanning a wide range of market segments.
- Symbiosis Investimentos has mixed native species plantation expansion projects in Brazil.
- Carbon is used by ACE as loan collateral and revenue to repay investors to provide income as other business models mature (see Appendices for investor profile on Althelia Climate Fund).

Recommendations jointly applicable to both companies and funds

Target financial and carbon-linked returns

Barrier addressed: Market uncertainties and pricing challenges; low risk-adjusted returns

Theme: Carbon

"Investors are interested in carbon pricing data and identifiable future markets. This is what comes up again and again." [Investor]

Why – investors are increasingly interested in carbon asset components of FSLU projects as a means of improving returns and diversifying risk. In addition, the corporate sector's interest in sourcing nature-based removal credits to fulfil net zero pledges also offers another client base for investors to target. Several high-profile FSLU funds and projects now base their commercial strategy around a mix of timber, crop and carbon returns. However, projections and pricing of carbon removals are increasingly scrutinised.

Action – incorporate a mix of assets investor offerings to better appeal to a broader base of capital providers. For funds and companies not directly targeting carbon-focused markets and investors, there may also be value in offering carbon assets as collateral to certain investors, recognising lack of collateral can be a barrier to many. Business plan and fund portfolio design should therefore consider their target investor group and gather information to help them assess the extent to which project returns and financial models should be weighted towards carbon assets. Many funds cannot invest in 100% carbon-based models, although there are exceptions (e.g. AXA IM Alts' Natural Capital Strategy which can invest in 100% carbon opportunities).

Viability and value – this recommendation may be of interest to many, though not all, investors. Viability will depend on project and fund specifics. As it impacts strategic focus and requires broader buy-in, implementation may take longer than other recommendations.

Sources of further guidance and examples

- Climate Asset Management fund targeting corporate carbon buyers

Offer investor-friendly liquidity options

Barriers addressed: Liquidity challenges; misalignment with equity or debt instrument needs

Theme: Investment structures

"The main challenge is liquidity in forestry - you need to demonstrate proven cases which include exiting. Some partial exits are realised but we need to demonstrate a full cycle." [DFI]

Why – most investors (even 'patient' or concessional funding sources) require their funds back in 6-12 years, and normally at the lower of end this range. As most FSLU projects will realise only part of their returns in this timeframe, given long harvest cycles (in forestry, for example), liquidity is a priority. This barrier is made more complicated by the fact that investors do not have rigid rulesets for what constitutes acceptable liquidity. At the same time, FSLU often suffers from misalignment with debt and equity investment needs, being higher risk yet lacking the collateral and liquidity options that investors would need to compensate for this.

Action – use deal structures and terms which provide investors with clear exit routes, including:

- Liquidity events / predetermined windows allow sales of shares directly to investors in the project, new external investors, or intermediaries. This may be facilitated by pre-agreed share values.
- Certain share classes that can be converted or sold in exchange for assets the project has generated such as Verified Carbon Units, timber, or cash.
- Liquidity sleeves and other alternative exit structures, including self-liquidating shares.

Funds and companies should explore opportunities for securing concessional finance, including subordinated loans, impact-first equity investments, and guarantees from Development Finance Institutions (DFIs). The favourable terms provided can alleviate liquidity constraints.

Viability and value – as this is a major barrier for many investors, these liquidity options may be very valuable. Viability will depend on the extent to which liquidity has been built into the project design from the outset. This will impact the investment strategy and financial aspects of a company or fund.

Sources of further guidance and examples

- There may in future be the potential to link to 'liquidity facilities' such as the Octobre Liquidity Guarantee Facility (in development)

Conclusion

Where to begin?

The recommendations in this report and in the separate Appendices may feel overwhelming for some companies and funds. Although we feel all are worth considering, a starting point for any reader is to note their own journey to date - are you in the early stages of designing a fund or project, or are you well-established and seeking scale-up capital? This will determine the viability of certain recommendations - for example, re-aligning a fund's strategy and geographies some years into its lifetime may be impractical.

All these recommendations influence investability and implementing some of them even partially will be valuable whether at early or later growth stages. For example, getting third-party opinions on key market and financial projections, or formalising a partnership with a local NGO. A key challenge for many in the FSLU sector is demonstrating a track record since the sector itself is relatively new. But even here, it is possible to make headway by partnering with research centres, technical specialists, or companies or funds with experience in parallel, related markets.

Investors will often not invest in FSLU due to a variety of reasons, including team competency gaps, their low risk appetites, and some projects' low risk-adjusted returns. Companies and funds that have strong team track records and business models, diverse income streams (both financial and carbon), and which are based in suitable geographies will receive greater interest from investors. Currently, some investors favour more established FSLU sub-sectors such as timber forestry. However, actioning these recommendations should help a range of project types to increase their investment appeal. We hope this will ultimately bring closer the crucial goal of unlocking commercial investment in climate mitigation, adaptation, nature protection and restoration.

Implications for funds and companies

The majority of recommendations put forward do not demand significant shifts in strategy from funds or companies. However, there may be possible exceptions depending on a fund or company's circumstances. Tailoring fund vehicles to Limited Partners and geographies may require a degree of strategic shift which can take time to achieve. The same applies to diversifying income streams to enhance risk-adjusted returns or targeting financial and carbon-linked returns.

Does the pursuit of commercial investment require a less 'deep-green', high-impact focus? Not always. Five of our recommendations are 'no-regret' actions which strengthen the impact potential of projects or funds, **and** their financial viability. These are: 1) strong business plans, financial models, and comprehensive risk disclosures; 2) support from local government, NGOs and communities; 3) competent and experienced teams; 4) NGO pipeline partnerships; and 5) SFDR alignment. Note the latter two target funds only, not companies.

Focus on the business basics and financials

Throughout our research and consultations, we were reminded of capital providers' clear focus on reducing risks, achieving reasonable returns, and their need for confidence in teams and financial projections. The FSLU sector offers a seductive route into positively impacting environmental and social concerns, but commercial investors see through that allure and want investments that have a clear route to delivering returns within reasonable timeframes. We hope the four categories and nine themes of investment barriers we present will provide a useful framework for companies and funds considering how to increase their appeal to investors, and to retain a focus on business basics and financials.

Next steps

Please read the separate Appendices document accompanying this report. This explores additional investment barriers and associated recommendations and gives a sense of the relative viability and value of the recommendations, viewed collectively. Our recommendations are not exhaustive - funds and companies will continue to develop innovative ways to address the investor concerns we have identified, and we look forward to further efforts by FMO and the broader FSLU community to share experiences and good practices.
Information on FMO's ongoing work in the FSLU sector is available here https://mff.fmo.nl.

Acknowledgements
We are grateful to FMO and IFU for inputs through the project and particularly Amy Jansen and Christiaan Broekman from FMO for constructive feedback throughout the assignment. Individuals from 40 organisations provided us with invaluable insights during our analysis through a series of interviews from March to June 2023.

Report authors
The Terranomics consultancy team included Chris Knight, Jim Stephenson, Chris Moore and Tom Chellew. Terranomics is a consultancy with 20 years of experience working on public and private sector approaches to environmental challenges. We are focused on scaling up private sector investment and action in nature-based solutions and conservation.

Accompanying reports and appendices
You can find more information and detail in the separate Appendices accompanying this report.

The views expressed in this report are those of the Terranomics team. They do not necessarily represent those of FMO or the organisations referred to within.