

Asia's Deforestation Crisis: An Institutional Investor's Perspective

Before briefly addressing what investors can do to help tackle Asia's deforestation crisis, I would like to make five quick points about how investors currently interface with the industry.

Point 1: fund managers are generalists not specialists.

The SRI industry is at times guilty of over-estimating the expertise of investors. The words investors and expertise do not sit well together. They are an oxymoron. By definition we are generalists. At best, we know a little about a lot. We certainly don't know a lot about anything. For example, as emerging markets fund managers, we allocate our clients' capital to around 20 different sectors in over 30 different countries. The same day we are deciding whether to allocate capital to a forestry company in Malaysia, we may also be considering the relative investment merits of an Indian software company, a Hungarian pharmaceutical company or a bank in Brazil.

Point 2: The forestry industry in Asia is unfortunately amongst the most opaque sectors in the region, with some of the lowest quality managements.

The assets and operations are often thousands of kilometres away, and are inaccessible not only to investors and analysts, but also consumers and even auditors. It is very hard to see or touch anything. Contrast this with a brewing company for example, with an easily identifiable factory and beer bottles which sit on the shelves of supermarkets and bars. Unfortunately it has historically paid to cut corners in the industry. It has therefore tended to attract managements prepared to cut corners.

Point 3: Sustainable Forestry Management is a complex issue, with a myriad of different standards focusing on different practices.

Bear in mind point one. Fund Managers are never going to be in a position to fully comprehend the nuances of sustainable forestry management for original growth forests, new growth forests, eucalyptus plantations or palm oil. We will never be experts in biodiversity, chlorine-free bleaching, skidding, heli-logging or stripping.

Even an SRI or forestry junkie would find it hard to distinguish between all the different sustainability standards and codes of conduct which exist, be it the Forest Stewardship Council, WWF guidelines, CITES, ITTO guidelines, the Helsinki Process, the Montreal Process, national initiatives from Malaysia and Indonesia, ILO convention 169 or 138, etc. Last week, Marks & Spencers of the UK announced that they planned to work with the Tropical Forest Trust to develop their own standard!

Point 4: Rightly or wrongly, forestry is regarded by most investors as a cyclical industry

Investors in Asia are notoriously short-term. Indeed, this problem is worsening as hedge funds grow in prominence. Cyclical industries, such as forestry tend to attract a disproportionate number of short-term investors. For most, the primary catalyst for investing in forestry companies is a belief that the price of timber will rise, whether due to changes in Japanese inheritance tax laws stimulating new housing construction, or growing demand from China and India. Most investors will primarily be interested in identifying those companies which offer significant leverage to a rising timber price. They will rarely spend time analysing the long-term strategy or vision of a company they do not expect to be owning in six months time. Unfortunately, the shorter the time-horizon of investors the less relevant SRI issues become. I read a report last week claiming that investors “cannot afford to neglect the issue of sustainable forestry.” That depends on the time horizon of the investor.

Point 5: There are very few investable listed forestry companies in Asia

There was a rush of companies to the stock markets of South East Asia in the early 1990s. As timber prices fell, many of these went bankrupt, and now there is only a small handful left. Most of these have market capitalisations of less than US\$400m.

Bearing these five points in mind, what can investors do about Asia’s deforestation crisis? There are two very important steps which must be taken, although investors can play only a small role here. First, investors must reinforce the importance of a harmonisation of standards. What is urgently required is one standard covering both upstream and downstream and across different related sectors such as old growth, plantations and palm oil. The Forest Stewardship Council standard appears to be the best candidate for this, and we should do all we can to increase its appeal and coverage.

Better still, make it a tiered standard, with three levels. There are three reasons for doing this. First, it is very hard to get agreement from NGOs and industry on one standard. By creating a three-tiered standard there is much more chance of moving forward on this issue and generating agreement and consensus. Second, rather than persuade companies to take a giant leap towards best practices in sustainable forestry management, it is much easier to get them to take several little steps. Many companies don’t set off on the SRI journey, because the end-point appears to be so far away. Thirdly, tiered standards are a great way of generating peer group pressure. It is very effective to point out to companies that their peers are a step ahead of them in terms of their practices. “We see that your competitor has reached level 2 certification for all their operations. When are you planning to get there?”

Having harmonised the standard for sustainable forestry, the next challenge is to make it a listing requirement amongst relevant stock exchanges. These include Malaysia, Indonesia, Singapore, Hong Kong, Canada, London and New York.

For companies which are already listed, a three year timeframe should be introduced for compliance, with delisting the enforceable penalty for non-compliance.

Admittedly, getting this done will be a challenge. However, with a credible coalition of investors, NGOs and companies, a lot of persistence, hard work and luck, there is every chance of persuading one or two enlightened exchanges to demonstrate their commitment to sustainable forestry!

What about engaging with companies directly? This is difficult. There is an SRI business case, but it is not strong. Yes, there are penalties and fines, but they are often not enforced and it is easy to cheat. Yes, there is reputation or customer risk, but again this is not being enforced. Last week, Greenpeace published a study in the UK alleging that most large UK retailers still source a significant amount of their timber requirements from illegal loggers in Indonesia. Yes, concession terms are becoming stricter with more emphasis placed on the condition of the concession upon its return. However, a 25 year problem is someone else's problem for a management focusing on next year's profits.

So what can be done? The most important message that investors must give to forestry companies is that we require tangible evidence of the Company's commitment to sustainable forestry management before considering an investment. This is clearly easier with one internationally recognised standard in place. "What percentage of your operations currently meet FSC standards?" "Are you planning to have full compliance?" "If not, why not?" "If yes, by when, how much will it cost and what progress will you have made when we meet you in 12 months' time?"

Given the small number of listed forestry companies, perhaps investors can have greater leverage indirectly, through their investments in banks, shipping, retail or trading companies. Standard Chartered's decision to cease making loans to the forestry industry in Malaysia and Indonesia has provided us with a great tool to engage banks in South East Asia on this issue.

Finally, as a closet tree hugger my personal belief is that the most important question occurs at a much earlier stage. "Is this natural forest a resource to be monetised?" I'm not sure I would like my home referred to as someone-else's resource. The answer must only be yes if the proceeds are used for sustainable development purposes. Very little of the value created by destroying over 300 football fields' worth of old growth forests each hour in Indonesia is currently being used to promote sustainable development in Indonesia, yet alone in locally affected communities. I would certainly question whether repatriating the dividends or capital gains generated from cutting down old growth forests, to the doctors, lawyers and teachers who are our clients, would fit this philosophy.

An interesting suggestion currently under consideration, which might help to reduce the financial pressure for immediate forest mining and clear cutting, is to construct some kind of debt securitisation against the future cashflows that can be generated from a sustainably managed forest. This would provide an alternative way of generating up-front cashflows. Then again, it all depends what these cashflows are used for.

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