

Impact Investments in Sustainable Development Goal #15

LIFE ON LAND

Understanding investor preference and informing fund design



Product Development Platform Overview

The GIIN's Product Development Platform aims to accelerate the flow of capital to funds that seek to address the Sustainable Development Goals (SDGs). Through various activities, the Platform:

1. Supports diverse groups of asset owners¹ to articulate their interests in and needs related to investment products,
2. Provides a mechanism for fund managers to access that market intelligence, test and refine products, and ultimately raise capital, and
3. Enables those two groups to connect and work together.

As part of the Platform, the GIIN regularly hosts Product Structure Workshops, which are designed to inform the design of products that meet investors' needs, efficiently bringing market feedback to fund managers in the process of structuring and raising funds. The workshop also seeks to educate investors on the range of possible SDG-aligned impact investment products. More information on how to be involved in the Platform can be found on the back of this report.

Methodology

What follows is a synthesis of two successive Product Structure Workshops—one hosted in May 2019, by GIIN Investors' Council Member, Nuveen; and a second, hosted in October 2019, as part of the GIIN Investor Forum. Each workshop featured three fund managers, presenting on in-development fund products, and panels of asset owners, representing diverse institutions and clients, who provided feedback on those fund structures from their perspectives. The synthesis provided in this report is pulled from notes taken by GIIN staff at each session, presentation materials provided by fund managers, and follow-up calls hosted with asset owner panelists. These insights have not been attributed to individual investors, nor have the fund features been attributed to the fund managers, to maintain the neutral learning environment required for these workshops to be productive.

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This report would not have been possible without the contributions of the 13 asset owners and 6 fund managers who participated in these workshops. Their willingness to engage in technical conversations about their own and others' fund structures is essential to building a more collaborative impact investing market and to driving more capital towards achieving the Sustainable Development Goals.

¹ Throughout this report, asset owners are referred to interchangeably as 'asset owners' and 'investors'.



Investment Products Targeting SDG #15: Overview and Introduction

Impact investments aimed at achieving the targets of Sustainable Development Goal (SDG) #15: Life on Land have the potential to deliver critical social and environmental results at scale. SDG #15 calls to “protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation and halt biodiversity loss.” The estimated USD 5-7 trillion annual funding gap to achieve the SDGs is enormous, but addressing the targets that underly this SDG is imperative not only to the conservation and continued sustainability of ecosystems, but also to the survival of the planet.²

In the GIIN’s 2019 [Annual Impact Investor Survey](https://theGIIN.org/research/publication/impinv-survey-2019), real assets investment strategies (which include timber, agriculture, and other land use strategies aligned to SDG #15, as well as infrastructure and real estate) are the third largest asset class by AUM, yet still represent only 10% of invested capital and 1% of deals—a relatively small segment of the market. Trend data pulled from repeat respondents to the Annual Survey from 2014-2018, however, shows a significant 38% compound annual growth rate in allocation to real assets. The trend of growing allocation to SDG #15 is further confirmed by planned allocation data collected from 2019 respondents. Almost half plan to increase their allocations to food and agriculture—more than any other sector. Nearly a quarter of investors also plan to begin to assess timber investments—again, more than any other sector.³

In part because of this interest, in April 2019, the GIIN published [Scaling Impact Investment in Forestry](https://unctad.org/en/PublicationsLibrary/wir2014_en.pdf), which looked at the drivers of asset owner interest in forestry, as well as common features of impact funds, their revenue drivers, and impact management techniques. The report confirmed a strong demand from institutional and private investors for impact forestry products and built on [The Financial Performance of Real Assets Impact Investments](https://theGIIN.org/research/publication/impinv-survey-2019), released in 2016 and updated quarterly since, which found financial outperformance in impact funds relative to their conventional peers. Despite this outperformance and investor interest, many asset owners noted that they are often approached by fund managers who do not fully understand their portfolios’ needs; and fund managers noted that understanding investor demand and raising capital from large-scale investors is a significant barrier to expanding the asset class.

Given these findings, the GIIN hosted two successive workshops, bringing together asset owners with fund managers in the midst of structuring investment products. The workshops aimed to expose asset owners to a range of funds targeting SDG #15 and improve the alignment between investor needs and investable products. What follows is an analysis of those conversations, based on 13 participating investors and 6 fund managers. More information about the workshops and methodology can be found on the previous page.

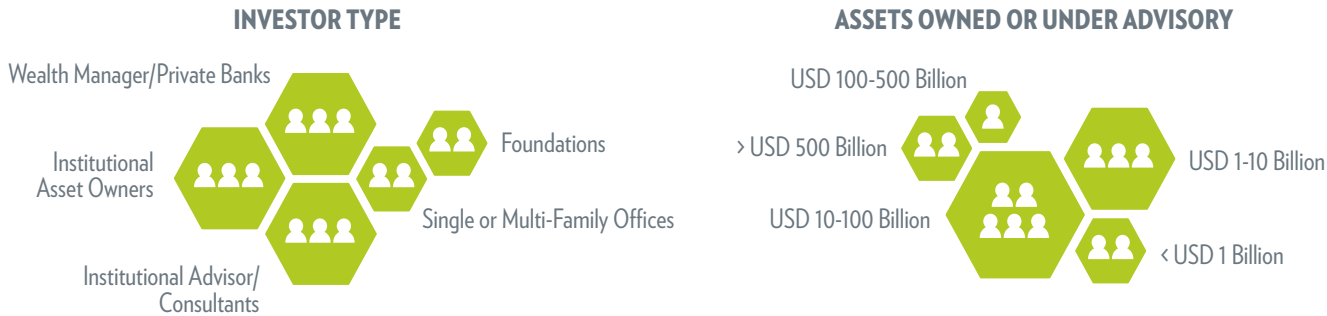
² https://unctad.org/en/PublicationsLibrary/wir2014_en.pdf

³ <https://theGIIN.org/research/publication/impinv-survey-2019>

Investor Panelist Profiles

A total of 13 asset owners (referred to in this document as ‘asset owners’ and ‘investors’ interchangeably) provided feedback on six fund products presented over two workshops. The investors—including both GIIN member and non-member institutions—represented family offices, foundations, institutional investors (and their advisors), and private banks/wealth managers. Investors’ experience investing in SDG #15 and real assets varied widely, with some panelists who had previously invested in several funds, and others who had just begun to make impact investments. All expressed an interest in the market and a willingness to consider the investment funds presented.

Investor Attributes



Fund Profiles

During each of the workshops, three impact fund managers in the process of developing investment products that contribute to SDG #15 presented their products to a panel of asset owners. The details of those funds can be found below.

Fund Attributes



⁴ Two funds invested in both agricultural land and timberland.

⁵ One fund was at sufficiently early stage to not have finalized return expectations, and so has been omitted here.

⁶ Returns figures are presented as net unlevered IRRs.



Investment Drivers and Constraints

INVESTORS NOTED THREE KEY DRIVERS FOR THEIR INVESTMENT IN SDG #15-ALIGNED PRODUCTS:

Noncorrelation with other asset classes

All investors acknowledged that investments in SDG# 15 were attractive for their risk profiles, relatively low volatility, and noncorrelation with other asset classes. Among timber and agriculture investment strategies, asset maturation is related to biological growth and not economic cycles, making funds in these sectors attractive from a diversification or portfolio efficiency standpoint. While many noted that revenues of those funds are still often tied to market cycles (i.e. sale of forestry products is correlated to housing starts), the flexibility to optimize timing of harvests to maximize return was an attractive feature of these funds and assets. Many of the institutional investors with experience in impact forestry and impact agriculture noted that the noncorrelation is, in fact, more pronounced with impact products because the diverse revenue streams, such as payments for ecosystem services (including carbon markets) and sale of land rights (conservation easements), are not tied to market cycles.

Opportunity for at-scale impact investment strategies in well understood asset class

Many impact investment funds are too small for institutional investor involvement. Particularly large-scale institutional investors noted that they were surprised and encouraged to see that many of the products tested were of appropriate scale for their mandates. Several also noted that their portfolios have historically had timber and agriculture carveouts, and therefore their teams have some level of expertise in the screening and diligence of managers in the asset class, making SDG #15-aligned impact investment products a bit easier to allocate to than other impact investments.

Diversity and depth of impact characteristics

Private investors (both family offices and wealth managers) noted that the diversity of social and environmental impacts associated with funds targeting SDG #15 were attractive to their clients. Most of the funds tested had strict ESG screens for asset acquisition and disposition, and actively managed the impacts of their investments on local communities, including job creation, rural economic development, support for indigenous tribes, and gender equity. Those investors representing multiple clients especially noted that the diversity of benefits from these strategies was attractive, given the varied desires of the clients they serve.

INVESTORS ALSO IDENTIFIED CONSTRAINTS IN FURTHER ALLOCATING TO SDG #15-ALIGNED PRODUCTS

Return expectations relative to other real assets investments strategies

While impact timber investments have historically outperformed their purely commercially-oriented peers and many investors noted attractive returns on a risk-adjusted basis, others surfaced the challenge of comparing timber and agriculture strategies to other real assets investment funds like infrastructure. When comparing to infrastructure and real estate, which can have similar asset qualities to timber and agriculture, return expectations for SDG #15 funds are often below the threshold they seek for the asset class.

Some structures differ from conventional counterparts

Often, impact investing funds targeting SDG #15 are structured somewhat differently from their traditional commercial peers. While those differences may be in service of better matching the needs of the asset (i.e. long lock-up period to match biological growth cycles of trees, etc.), the difference in fund structure makes the funds harder to explain to investment committees. Funds utilizing blended finance, similarly, can present challenges for investors to understand and explain. Additional details about these design features can be found on page 4, in Key Fund Features Explored.

Key Fund Features Explored

Ahead of workshops, investors identified several key features on which to focus conversations. During the two sessions, investor panelists shared feedback on the attractiveness of those fund features. A synthesis of those opinions is below.

FEATURE(S) DESCRIPTION	INVESTOR REACTIONS
Open-Ended vs. Closed-Ended Structure	Open-ended funds better match the tenure of the asset, and allow for better management of social and environmental performance: Most investors noted the desire for fund structures to match the tenure of the underlying assets—the forests and agricultural land. In the case of forestry, biological growth cycles of trees are at minimum 20-30 years. The traditional private equity fund structure, with a term of 10-12 years, therefore, is not an optimal match for forestry assets—particularly if the manager is engaging in afforestation⁷ or reforestation.⁸ Several investors with long-term liabilities (i.e. pension funds, life insurance companies), and those with flexibility in their portfolios (i.e. family offices, foundations), expressed an interest in finding investment structures that better match the tenure of the asset. Two of the fund managers presented open-ended fund structures with perpetual terms that allow those managers to better time asset disposition with market cycles, and to better manage and maximize the social and environmental outcomes associated with the asset. Open-ended structures are often difficult to account for in asset allocation: While open-ended fund-structures better match the tenure of the underlying assets, they are often hard for investors to account for and compare to more traditional structures. Several investors noted that they include holding companies and other open-ended vehicles in their direct investment portfolio. Others included in their private equity secondary asset allocation. Many of the investors in the workshops were not asset-class specialists but rather sustainable or impact investing specialists who worked with their peers on the asset class desks to screen and diligence across impact criteria. They noted that for any non-traditional structure (such as these open-ended structures), finding the appropriate asset class specialist to consider the fund is an additional hurdle for that fund to overcome in the fundraising process. Open-ended fund structures create incentives for managers to inflate or deflate valuation; governance and independent asset valuation is key: Many investors noted concern over the valuation processes of open-ended fund structures. Perpetual vehicles with interim liquidity features provide incentives for managers, at opportune times, to inflate or deflate asset valuation. As such, governance of open-ended funds comes into sharper focus than closed-ended peers. In anticipation of these concerns, both fund managers presenting open-ended vehicles noted that they validate their asset valuations with independent auditors. For most investor panelists, that was a satisfactory solution, but they did express that their investment committees might be hesitant, or ask for additional governance of valuation practices. The development of fixed income products represents an opportunity to tap into a much larger pool of assets: The asset allocation strategies of most investor panelists was a primary barrier to scaling additional investment into SDG #15-aligned products. At most, alternatives made up a third of their portfolios, with far more in fixed income and equities. Developing fixed income products, therefore, could open up a much larger pool of capital for SDG #15-aligned fund managers to access. The fixed income product tested in this workshop was attractive to investor participants but was at an early stage of development. Institutional investors, in particular, noted that global interest in green bonds and climate bonds could work to the advantage of managers and issuers structuring fixed income products.

⁷ Afforestation involves planting trees in an area that was not previously a forest.

⁸ Reforestation involves replanting an area with trees.

FEATURE(S) DESCRIPTION	INVESTOR REACTIONS
Use of Blended Finance	Investors noted different levels of comfort with blended capital⁹ stacks: Most family office/wealth advisory investors noted that they were comfortable with the concept of blended finance and had previously made or advised on blended deals. Several noted that for their clients, the combination of available risk tolerant capital, and desire to prove untested investment strategies make blended structures attractive—whether they are coming in at the catalytic or commercial levels. The institutional investors present were mixed in their opinions on blended structures. Only one had made or invested in a blended finance fund, and others noted that while the concept is attractive—particularly in geographies or markets they have not yet entered, the structures tend to be too complicated for them to easily explain to their investment committees. Others noted that they typically like to invest with aligned LPs. Investing alongside foundations or donor agencies, who often provide the catalytic capital to blended capital stacks, and who are driven more by the impact than the financial outcomes, is an important consideration for their investment committees. Fund managers need to very clearly articulate the specific risk being mitigated through the use of blended finance: Foundation investors—those providing catalytic capital to support the development of blended finance funds— noted the need to clearly define the specific risk(s) being mitigated with their capital. Other investors also noted that they are unwilling to deploy catalytic capital into markets that will not be mature enough to receive commercial capital in subsequent funds or investments. In other words—the specific risk being mitigated via catalytic capital in a fund structure should be clear in fund documentation; and should be effectively de-risked through the lifecycle of one fund. An example is geographic risk—wherein a given region has not seen scaled investment in timber. A first loss tranche or guarantee of a fund in that geography might allow commercial investors to allocate capital. If the fund is successful, those same commercial investors may provide follow-on investment in a capital stack that is not blended because the perception of geographic risk has been reduced. More persistent factors like currency risk (for funds investing in geographies with highly volatile currency markets) were less attractive to catalytic capital providers because it is unlikely that the demonstration effect of a blended fund will lead to reduction in the actual or perceived currency risk to the point where purely commercial capital could enter. Therefore, fund managers should also have a clear theory as to how the provision of that blended capital will mitigate the risk in perpetuity and should not expect to be able to attract that amount of catalytic capital in follow-on funds. Calculation of appropriate amount and type of catalytic capital remains a challenge: For investors who were comfortable deploying catalytic capital (foundations and some family offices), and those commercial investors comfortable investing in blended capital stacks, the question of how to appropriately calculate the amount of concession to provide remains. All investor participants noted that there is not a broadly accepted, standardized way of determining the appropriate concession, and is subject to negotiations between commercial and catalytic capital providers. In part, this is why blended finance funds can prove time- and resource-intensive to structure and invest into.
Assurance and Monetization of Conservation Outcomes	Sustainability certifications are ubiquitous, and most investors consider them ‘table stakes’: In timber investment, FSC and SFI, among others, are widely used to certify the sustainability of forests. Most investors we spoke with considered them to be a minimum threshold for impact assurance. Most also noted that they require managers to report on additional metrics related to the social and environmental performance of the assets. The ubiquity of these certifications is uncommon among impact sectors, and investors noted that use of them increased their confidence that the impacts sought were actually being achieved. Investors expect further monetization of the social and environmental impacts of SDG #15 investments: Many of the funds tested generated revenue via ‘payments for ecosystem service’ markets. This includes voluntary and compulsory carbon markets, water credits, and other regulatory schemes. Most investors noted that, while these markets are at present not fully developed and therefore can be perceived as risky, they are attractive because they offer alternative revenue streams to those more traditionally employed by timber managers (namely, sale of forestry products). Most investors also noted that as the targets that underly various international agreements like the SDGs and Paris Climate Accord are implemented as policy, these markets will likely grow, and the costs of ecosystem services will increase. For investors seeking to achieve carbon neutrality in their portfolios, SDG #15 products are strong contributors: Several investors, particularly institutional and private, noted that their organizations are working toward carbon neutrality across the portfolio (usually due to a top down mandate or pressure from clients). The need to decarbonize their portfolios makes timber and agriculture investments, which can result in net negative carbon emissions when managed appropriately, especially attractive. One investor noted that their investments in timber are seven times more effective at reducing the carbon emissions of the portfolio than their sustainable energy investments. Foundation and family office respondents also noted that increasingly, evidence suggests that sustainable management and conservation of forests are the most effective commercial means of combatting climate change.

9 The GIIN defines blended finance as a strategy that combines capital with different levels of risk in order to catalyze risk adjusted, market-rate-seeking capital into impact investments.

Get Involved in the GIIN's Product Development Platform:

The GIIN convenes workshops and working groups aimed at clarifying asset owner mandates and supporting fund managers to structure investment funds that meet those mandates. These conversations are open to GIIN members and external asset owners interested in learning more about in-development investment funds and contributing to the collective intelligence of the market. These conversations often take the form of product structure workshops, which bring together organizations dedicated to expanding a given SDG-aligned product segment. If you are interested in participating, please email productdevelopment@thegiin.org.

About the Global Impact Investing Network

The Global Impact Investing Network (GIIN) is the global champion of impact investing, dedicated to increasing the scale and effectiveness of impact investing around the world. Impact investments are investments made into companies, organizations, and funds with the intention to generate positive, measurable, social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets and target a range of returns from below market to market rate, depending upon investors' objectives. The GIIN builds critical infrastructure and supports activities, education, and research that help accelerate the development of a coherent impact investing industry. For more information, please visit www.thegiin.org.

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