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DESIGN GRANT CASE STUDY

TLFF INAUGURAL TRANSACTION: CORPORATE SUSTAINABILITY BOND FOR NATURAL RUBBER PRODUCTION

JANUARY 2019

EXECUTIVE SUMMARY

The Tropical Landscapes Finance Facility (TLFF) is a multi-stakeholder partnership between the UN Environment Programme (UN Environment), The World Agroforestry Centre (ICRAF), BNP Paribas, and ADM Capital. TLFF aims to finance local projects and companies in Indonesia that are focused on green growth and sustainable rural livelihoods, in line with the Indonesian Government priorities, the Paris Agreement and the Sustainable Development Goals.

In February 2018, TLFF completed its inaugural transaction, a landmark $95 million long-dated sustainability bond to finance sustainable natural rubber production across heavily degraded concession areas in the Jambi and East Kalimantan provinces. Michelin, the global tire manufacturer, will act as an off-taker of at least 75% of future production, and USAID's Development Credit Authority (DCA) provided a partial credit guarantee. The transaction was Asia's first corporate sustainability bond, with an innovative multi-tranche class structure that appeals to investors with diverse risk-return and tenor requirements. Class A notes, comprising $30 million, were rated Aaa by Moody's and subscribed by institutional investors from Southeast Asia, such as life insurance companies.

The structuring and launch of the sustainability bond offered a number of insights and lessons, such as 1) demonstrating that there is demand from institutional investors for sustainable investment products, 2) products such as USAID's DCA guarantee are highly valued, and more similar products are needed, and 3) investor education is critical for esoteric structures and deal sponsors should incorporate these activities into their work planning.

SYNOPSIS

Anchor TLFF stakeholders	UN Environment Programme (UN Environment), World Agroforestry Centre (ICRAF), BNP Paribas, ADM Capital
Use of proceeds	To plant rubber trees across concession areas in Indonesia's Jambi and East Kalimantan provinces
Issuer	TLFF I Pte. Ltd
Borrower	PT Royal Lestari Utama (RLU) and subsidiaries
Off-taker	Michelin (at least 75% of rubber production)
Lead arranger	BNP Paribas
Facility manager	ADM Capital
Partners	USAID's Development Credit Authority (DCA), ADM Capital Foundation
Close date	February 2018
Bond tenor	5-15 years
Transaction structure	$95m total size: • Class A: $30m, 15 yrs, Aaa rated by Moody's, 4.14% coupon p.a. • Class B1a: $20m, 15 yrs, 9.00% coupon p.a. • Class B1b: $15m, 5 yrs, 8.38% coupon p.a. • Class B1c: $15m, 7 yrs, 8.88% coupon p.a. • Class B2: $15m, 15 yrs, 2.00% coupon p.a
Guarantee	• Guarantee on $70m (guaranteed loan portion): $3.5m of first losses absorbed by RLU and 50% of remainder (50% of $66.5m) absorbed by USAID, capped at $33.25m • Pricing: Origination fee and utilization fee
Target impact	• 27k hectares of land for conservation in RLU concessions and protection of wildlife • 16k fair-wage jobs for employees and value creation for 24k smallholders

INTRODUCTION

Despite projections that Indonesia will be among the top five economies in the world by 2030, it is estimated that Indonesia suffers a funding gap of more than $20 billion for projects that support the country's climate and development commitments. With a population of 260 million people and 17 thousand islands, Indonesia benefits from significant human and natural resources. While Indonesia has achieved steady economic growth, a number of issues remain as barriers to future sustainability, including deforestation, greenhouse gas emissions, rural electrification, and poverty alleviation. Indonesia faces a critical need to mobilize financing at scale for green growth, climate change mitigation, conservation, and rural livelihood projects.

The Tropical Landscapes Finance Facility (TLFF) was conceptualized by a multi-stakeholder group comprised of UN Environment, World Agroforestry Centre (ICRAF), BNP Paribas (BNP) and ADM Capital. The objective was to drive long-term investment capital into commercially viable and sustainability-focused projects and companies in Indonesia. The consortium focused on Indonesia because significant areas of its forest lands are threatened by conversion to agriculture and an estimated 25% of the population still lives on $2 a day or less. The TLFF founding partners recognized an opportunity in the growth in global capital earmarked for sustainable and green investments, but also a significant lack of investment products aligned to interested institutional investors. The TLFF was launched by the Coordinating Minister for Economic Affairs of the Republic of Indonesia on 26 October 2016.

The TLFF is an innovative financial platform that aims to connect commercially-priced, long-term financing with local projects and companies focused on green growth and sustainable rural livelihoods in Indonesia. In November 2016, Convergence awarded a grant to ADM Capital and ADM Capital Foundation to help design and structure the initial TLFF deal pipeline. The grant was awarded at a critical juncture in the facility's development. Convergence was interested in the TLFF's potential to attract institutional capital to key development sectors, with clear emphasis placed on both scale and replicability. With ongoing support from UN Environment to the TLFF Secretariat, coupled with grant funding from Convergence to ADM Capital and ADM Foundation, the TLFF completed its inaugural transaction: a $95 million sustainability bond to finance sustainable natural rubber plantations in heavily degraded landscapes.

The sustainability bond is a groundbreaking blended finance transaction given its scale and appeal to different types of investors. The bond offers investors a commercially appealing investment opportunity, while prioritizing environmental and social outcomes in a developing country. This case study will focus on the inception and design of the TLFF's first transaction – the first of many to come under the TLFF umbrella. The TLFF has a robust pipeline of agriculture and energy opportunities that represents over $1.5 billion in aggregate.

FACILITY DESIGN

The TLFF is focused on two priority areas identified by the Government of Indonesia: sustainable agriculture and renewable energy. The steady-state version of the TLFF is envisioned to consist of 1) a revolving debt facility and 2) a parallel technical assistance fund, which together will provide right-sized financial solutions to companies and projects throughout their development cycles – from the 'Construction Phase' to the 'Harvest Phase'. The revolving debt facility is envisioned to be backed by 'contingent funding commitments' from development finance institutions (DFIs) and aid agencies to provide credit enhancement in the case of default.

Under the structure, ADM identifies and manages the environmental and social (E&S), as well as the financial aspects of the projects. Once these projects have reached the Harvest Phase – achieving sufficient scale to be aggregated and securing off-takers or corporate guarantees – a Medium-Term Note program will be arranged and sold by BNP to institutional investors, providing liquidity to the companies managing the projects and enabling the facility to support additional opportunities.

Contingent funding commitments are essential to realize the steady-state version of the TLFF. To ensure prospective DFIs and aid agencies are comfortable providing contingent funding commitments at the facility level, the TLFF team is first working towards demonstrating the viability of the project pipeline by closing pilot transactions. This allows TLFF to build credibility and track record before implementing the portfolio approach.

PILOT TRANSACTION

In February 2018, the TLFF announced its inaugural transaction. The $95 million long-dated sustainability bond will lend to PT Royal Lestari Utama (RLU), a joint venture established in December 2014 between France's Groupe Michelin (49%) and Indonesia's PT Barito Pacific (51%). RLU will use the bulk of the proceeds to plant rubber trees across degraded concession areas in the Jambi and East Kalimantan provinces.

RLU sought to develop a large-scale sustainable rubber plantation in an area of Indonesia suffering from deforestation, in part from encroachment. The plantation requires a long period of development, since rubber trees require 6-7 years of growth before production. A project of this nature and size requires significant upfront capital, with an extended timeline for repayment. Investors need to be comfortable with the cyclical nature of production, the tenor of the project, the creditworthiness of the borrower, as well as the risks associated with commodity volatility. Despite a growing appetite around sustainable land use and responsible financing, RLU faced significant barriers to identifying viable sources of commercial capital at a required tenor.

The relationship between the TLFF and RLU was based on a shared vision of green growth and commercial viability. In addition to promoting sustainable production and environmental conservation on degraded land, the rubber plantation has a strong focus on capacity building and improved efficiency for smallholder farmers, as well as agricultural infrastructure. The scale and blended element of the sustainability bond allowed for notes to be effectively securitized and tranched to match the risk return profiles of diverse investors, ranging from impact-first investors to institutional investors in Southeast Asia (e.g., life insurance companies). Although the TLFF had a number of high potential projects in the pipeline, RLU was selected as the pilot because of its strong alignment with both the TLFF's and the Government of Indonesia's development priorities.

USAID's DCA guarantee was a critical component of the capital structure and unlocked capital during the subsequent fundraising efforts. The transaction was attractive to USAID as it aligned well with its sustainable landscapes mandate, which focused on conserving biodiversity and natural resources.

CAPITAL STRUCTURE

The RLU transaction was Asia's first corporate sustainability bond and one of the largest guarantee exposures that USAID's DCA holds to a single company. The novelty of the structure is premised on the multi-tranche notes, which include two main note classes (A & B). This flexible structure was championed by BNP as the lead arranger. The bond is made up of senior fixed rate notes with varying risk profiles, tenor, and coupon payments (see Figure 1). Class A notes are investment-grade, which enabled participation from institutional investors, particularly those with an appetite to allocate capital towards sustainable investments. Class B1 and B2 notes targeted investors with explicit impact mandates that had the capacity to take on greater risk, across varying tenors and return expectations.

Class A notes are rated Aaa by Moody's. This is possible because of the structuring efforts led by BNP. The maximum coverage USAID can provide for any single transaction is 50% of principal. In this case, TLFF will use any payouts from the USAID guarantee to fully cover the class A note holders, leaving the class B noteholders uncovered.

Class	$	Type	Tenor	Rating	Coupon (p.a.)
A	30m	Amortized	15 yrs	AAA	4.14%
B1a	20m	Amortized	15 yrs	--	9.00%
B1b	15m	Bullet	5 yrs	--	8.38%
B1c	15m	Bullet	7 yrs	--	8.88%
B2	15m	Bullet	15 yrs	--	2.00%

Figure 1: Characteristics of note classes

Within the $70 million guaranteed loan portion, RLU is responsible for first losses up to 5% ($3.5 million) in the case of default. Following this first loss, USAID provides a partial guarantee that will cover 50% of the remainder (equal to $66.5 million after deducting first loss portion), amounting to $33.25 million.

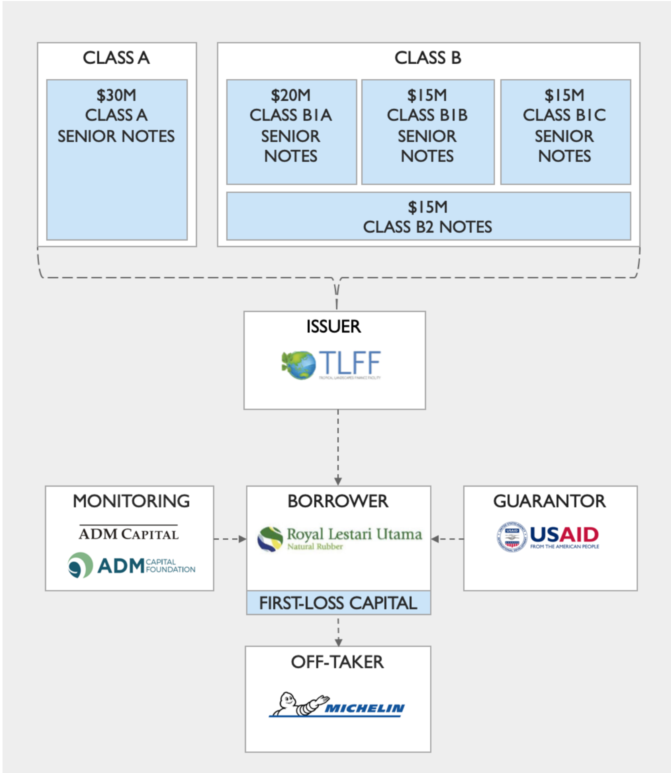

Figure 2: Overview of transaction structure

A key aspect of the structure was the off-take arrangement Michelin provided to RLU, where Michelin agreed to purchase up to 75% of the future rubber production. This was attractive to investors because it increased certainty around RLU's future cashflows and loan repayments.

To ensure RLU's adherence to TLFF ESG Standards, ADM will carry out E&S oversight and monitor the proceeds to RLU throughout the life of the project, as well as conduct annual audits to verify the results.

FUNDRAISING FOR CLASS A & B NOTES

While the business case for ESG investing is well established, traditional investors remain hesitant to fully integrate these projects into their portfolios, particularly where investments require longer tenors with higher perceived financial and reputational risks. However, at the same time, global commodity supply chains are under heavy pressure to show real action around sustainability. The result is a cautious increase in demand for sustainable investments in the space globally. Given these conditions, the TLFF transaction offered a unique value proposition to investors who wanted to invest in environmental and social opportunities,.

Ultimately, BNP led a successful fundraising process that resulted in participation from a diverse set of investors. Investors included: impact investors with a long time horizon and a strong focus on impact; life insurance companies looking to align their portfolios with ESG, but less willing to take on additional risk; and the private wealth market (i.e., high net worth individuals).[1] The intended distribution of the payouts from the USAID guarantee offered institutional investors the opportunity to partake in a project with high social and environmental returns with a comparable risk-return profile to non-social and environmental investment opportunities. The support from the Government of Indonesia also played a key role in giving comfort to investors. The team had four main reflections from the successful fundraising effort:

- Risk perception: Commercial investors viewed the rubber industry in Indonesia as a high-risk sector, particularly carrying reputational risk if the transaction went sideways. Impact investors who had experienced their own challenges working in the market also had reservations around working in the space. As a result, the credit quality of the borrower and off-take agreement were examined with scrutiny. Investors found they had to dedicate significantly more time and resources than expected to diligence the transaction.

- Due diligence capacity and motivations of different investors: Due diligence capacity and ESG reporting requirements differed across investor types. For instance, life insurance companies had little capacity to conduct intensive due diligence, and ESG investments only made up a small portion of their portfolios. In contrast, dedicated impact funds had specific mandates and capacity to conduct intensive due diligence. It is critical to understand the constraints of investors, specifically institutional investors, and provide sufficient support (e.g., well prepared documents for due diligence) to overcome those constraints,

- Investor education: Given the esoteric nature of the transaction, a substantial amount of time was required to make investors comfortable with a non-conventional financial structure.

- Administrative complexities: Working across numerous partners, time zones, and teams provided administrative and timing challenges. This required patience and commitment from all partners to move the transaction from a conceptual vision to a concrete structure that would reach financial close.

ANTICIPATED IMPACT

The transaction has specific environmental and social impact goals and metrics aligned to the SDGs. In particular, the sustainability bond is aligned to Goal 8 (Decent Work and Economic Growth), Goal 12 (Responsible Consumption and Production), Goal 15 (Life on Land), and Goal 17 (Partnerships for The Goals). The key impact metrics focused on 1) forest ecosystem retention and biodiversity protection, 2) improved rural livelihoods, and 3) reduced emissions.

On forest ecosystem retention and biodiversity protection, the project covers 88,000 hectares of concessions, out of which around half will be set aside for protected areas and livelihoods. The protected areas include a 9,700 hectare wildlife conservation area in Jambi that is co-developed by World Wildlife Fund (WWF) and RLU, and funded by Partnerships for Forests (P4F). In Jambi, the plantations and protected areas are intended to act as a productive buffer zone to help protect the 143,000 hectare Bukit Tigapuluh National Park from further deforestation. This will also help protect endangered species such as elephants, orangutans, tigers, and bears. Following a 2015 High Conservation Value/High Carbon Stock study of the concessions, WWF worked with RLU to set aside "go" and "no-go" areas for planting.

In total, 58,000 people in surrounding rural communities in Jambi are expected to benefit. An estimated 16,000 people will be employed and trained by RLU in its plantations and re-milling facilities at project maturity, and 24,000 local farmers will receive access to technical assistance, agricultural infrastructure, rubber tapping, extension services, guaranteed fair pricing, and integration into the RLU supply chain. A rubber smallholder program is in development under a community partnership program (CPP). Currently, smallholders produce average 1,000kg/ha/year of rubber in Indonesia. Improving yield will be a goal of the CPP, since plantations should produce about double the current amount.

Finally, the project has the potential for significant emissions reduction, as well as additional carbon sequestration from reforestation and regeneration. A detailed baseline carbon assessment is close to complete, funded by USAID's Green Invest Asia. To ensure that these impacts are implemented and measured, a detailed Environmental and Social Management System (ESMS) was developed in partnership with Daemeter.

[1]At this time, TLFF is unable to publicly share specific investor names due to confidentiality agreements.

This system outlines the core objectives, output indicators, reporting schedule, responsibilities, and impact indicators. Documents under this ESMS include an environmental and social action plan, which will be audited for progress annually, an integrated forest management plan, and a community partnership program.

Vigeo Eiris, a global sustainability consultant and approved verifier for the Climate Bond Initiative, reviewed the project and deemed the notes Sustainability Notes, aligned with the International Capital Market Association (ICMA) Sustainability Bond Guidelines. Further, the social and environmental objectives were considered defined, precise, and relevant, according to the guidelines. Vigeo Eiris concluded that the project's contribution to sustainable development would be positive, emphasizing the expected benefits to biodiversity protection, and improved livelihoods of rural communities.

KEY INSIGHTS

The design and implementation of the first TLFF transaction offered some insights and lessons that are applicable not only for subsequent transactions, but for similar multi-stakeholder blended finance structures:

- There is increasing appetite from institutional investors for sustainable investment products with appropriate risk/return profiles: The combination of commercial returns and E&S impact, as well as strong governance, is being sought out by institutional investors. However, there remain too few structures that are able to provide this combination of factors at acceptable levels of return and risk. There is a need for more offerings, such as the TLFF's inaugural sustainability bond, that appeal to various investors with differing motivations and risk/return appetites.

- USAID's guarantee was critical to raising commercial investment, and there is a need for more of these types of products: All the stakeholders involved in the transaction emphasized the importance of the guarantee and the need for more guarantee-like products in the market. USAID's partial guarantee allowed BNP flexibility in structuring the transaction, and for RLU to access investor pools that were previously deemed inaccessible. The catalytic effect of the guarantee demonstrated the importance of growing the market for more products like USAID's DCA.

- As can be expected, multi-stakeholder partnerships are complex, and must be managed carefully to achieve success: Complex, large-scale blended finance structures typically require multiple partners to succeed. Particularly in emerging markets, this often results in numerous stakeholders situated in a number of legal jurisdictions across varying time zones. Managing meetings, legal contracts and coordination across all stakeholders is time consuming and challenging. However, having partners who are committed, share a vision, and have clearly defined roles, are key factors in making the model both achievable and scalable.

- Investor education is critical when approaching institutional investors with novel blended finance structures: The TLFF consortium, and in particular BNP, invested a significant amount of time with institutional investors to explain the more esoteric aspects of the structure such as the USAID's DCA guarantee and ESG metrics. Deal sponsors should incorporate these activities in their fundraising work plan.

SOURCES

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ABOUT CONVERGENCE