CASE STUDY | AUGUST 2023

Tropical Asia Forest Fund 2 (TAFF2)

CONVERGENCE
BLENDING GLOBAL FINANCE

AUTHOR(S):

Claire Njoki, former Senior Associate, Convergence

SUGGESTED CITATION:

Convergence Blended Finance (2023). Case Study: Tropical Asia Forest Fund 2 (TAFF2). Convergence Report.

ACKNOWLEDGEMENTS:

This case study was made possible by the support of the Good Energies Foundation.

Executive Summary

New Forests, a global investment manager of nature-based real assets, launched fundraising efforts for the Tropical Asia Forest Fund 2 (TAFF2) in 2018 with an overall targeted size of $300 million. The Fund seeks to invest in sustainable plantation forests and nature-based solutions opportunities in Southeast Asia and establish a diversified portfolio for end markets such as timber, rubber, carbon, and potentially other ecosystem services.

TAFF2 employs a blended finance approach, which enables the Fund to achieve impact targets while delivering commercial returns. The Fund has two tranches – Class A and Class B shares. The Class A tranche targets commercial forestry returns which are commensurate with market expectations, while the Class B tranche targets lower returns than Class A shares. This tiering allows the Fund to set aside an impact budget to fund activities to generate impact outcomes around climate change mitigation, biodiversity enhancement and community development. The Fund is also supported by technical grant funding for pre-due diligence and due diligence provided by Restoration Seed Capital Facility, Green Invest Asia and Partnerships for Forests. The blended structure seeks to moderate the overall risk-return profile of the Fund to mobilize capital into high impact forestry and nature-based solutions projects, targeting climate, community, and biodiversity benefits while also meeting investor objectives.

TAFF2 presents important insights including:

- (i) The importance of involving communities to create shared interests in achieving conservation and climate objectives.
- (ii) Technical assistance funds can increase the bankability of a Fund's underlying investments.
- (iii) Blended finance structures can be utilized to create financial returns alongside impact creation activities.
- (iv) Investment readiness can play a role in increasing the odds and flow of successful outcomes by building a pipeline of investment opportunities well in advance.

SYNOPSIS

FUND MANAGER	New Forests Asia (Singapore) Pte Limited
FUND VINTAGE	2022
MANDATE	To provide institutional investors with exposure to sustainably managed plantation forestry and nature-based solutions investments, primarily in Southeast Asia.
PRIORITY REGION	Malaysia, Indonesia, Vietnam, Laos, Cambodia, Thailand, and the Solomon Islands.
SECTOR	Forestry and Nature-Based Solutions
TARGET FUND SIZE	$300 million
CAPITAL STRUCTURE	*Class A* • $250 million target (commercial equity) *Class B* • $50 million target (concessional equity)
FUND TERM	10 years, with 3 potential subsequent extensions of 1 year each by the General Partner with approval of the Limited Partners (by special majority votes at 51%, 75%, and 75% of Aggregate Commitments respectively)
IMPACT TARGETS	"Impact Activities" focused on positive climate change mitigation, biodiversity enhancement and community development
ESTIMATED IRR	*Class A* • mid double digits (%) *Class B* • high single digits (%); (All returns noted are nominal, gross, denominated in US dollars) • Target net cash yield in US dollar terms on invested capital of 1–2% after the initial investment period of 4 years

Introduction

Southeast Asia is home to nearly 15% of the world's tropical forests and includes at least four of the twenty-five globally important biodiversity hotspots. However, increased growth in population and GDP has fuelled massive deforestation in the region, as demand rises for wood and its products. Moreover, the forestry sector is characterized by a concession model that involves a government agency granting a commercial enterprise the right to large-scale resource extraction such as through logging and/or land use for perennial or annual crops, usually in the form of a long-term lease. This has further enabled widespread deforestation in the region; Southeast Asia has lost 80 million ha of forest between 2005 and 2015, which translates to a forest loss rate of around 8 million ha per annum.

There is an urgent need for commercial enterprises to employ investment strategies that protect and restore ecosystems. New Forests, a global investment manager of nature-based real assets founded in 2005, saw an opportunity to invest in capital efficient, sustainably managed forest estates. To this end, New Forests established the Tropical Asia Forest Fund 2 ("TAFF2" or the "Fund") which aims to capitalize on the long-term investment opportunities in sustainable plantation forestry and nature-based investments, demonstrating a strategy to deliver carbon credits alongside the sustainable production of traditional commodities, such as timber and rubber. TAFF2 is a follow-on to New Forests' first fund, Tropical Asia Forest Fund (TAFF), which closed at $170 million in 2012.

Design & Funding

TAFF2 was launched in 2022 with a target size of $300 million. The Fund held a first close in March 2022 and an interim second close in October 2022, resulting in a current committed capital of $130 million. The Fund seeks to invest in sustainable plantation forests and conservation nature-based solutions opportunities to establish a diversified portfolio for end markets such as timber, rubber, carbon and other potential ecosystem services in the sector with a focus on Malaysia, Indonesia, Vietnam, Laos, Cambodia, Thailand and the Solomon Islands.

TAFF2's environmental and social policy framework promotes the sustainable management of integrated landscapes to optimize financial returns and impact outcomes and restricts the Fund from investing in any deforestation of high carbon stock (HCS) and high conservation value forests (HCVF).

While TAFF and TAFF2 employ similar investment approaches, New Forests saw an opportunity to use a blended finance structure in TAFF2. Here, the addition of a concessional tranche (Class B), enables the Fund to achieve impact targets while delivering commercial returns. An amount equivalent to 50% of the concessional tranche will be used to target Impact Activities focused on climate action, community engagement, protection of livelihoods and biodiversity conservation in the Fund's plantation forestry and conservation nature-based solutions portfolio.

TAFF2's use of blended finance enables the Fund to improve returns by investing in

- i Impact Activities that provide potential alignment with developing carbon and ecosystem services markets,
- ii more greenfield plantations, and
- iii investments that target an earlier positive cashflow.

The Fund aims to improve its operational capacity, efficiency and scale as well as provide asset enhancement through improving forest quality and asset resilience.

When managing TAFF, New Forests experienced limitations including longer due diligence processes and costs associated with transactions that did not close (dead deal costs) partly as a result of New Forests' high environmental and social standards. Influenced by this experience, New Forests also raised capital for technical assistance for pre-due diligence and due diligence support for TAFF2. Furthermore, the team also established the blended finance structure to help adopt an integrated land use planning approach that would maximize impact and financial returns.

Through its activities, New Forests aims to demonstrate how the integration of commercial forestry investments with activities such as ecosystem restoration, reforestation, and community forestry can lead to better financial returns, long-term sustainability outcomes, and operational resilience.

In its fundraising activities, TAFF2 has been targeting both foundations and donor agencies for concessional commitments and institutional investors for the commercial tranche (Class A). While there was notable interest from impact-focused investors in the concessional tranche, most institutional investors exhibited reservations due to their limited exposure to the region and perceived risks associated with the asset class.

In 2019, The David and Lucile Packard Foundation was the first investor to approve a $10 million investment into TAFF2. Of this amount, $2.5 million was channelled into TAFF2's innovative "impact tranche" while the remaining $7.5 million was invested in Class A. Packard's investment will serve as a pilot for incentivising and accelerating deeper climate and conservation outcomes within larger, more established fund managers at scale.

New Forests also signed an agreement with the Restoration Seed Capital Facility in 2022 to support early-stage development of forest restoration projects in developing countries that contribute to climate adaptation and mitigation, biodiversity, and sustainable livelihoods. Previously, New Forests also signed a Memorandum of Understanding with the Green Invest Asia program of the US Agency for International Development (USAID) which supported funding of selected technical assistance activities in the due diligence phase of investment activities. New Forests had also executed an agreement with Partnerships for Forests (P4F), which was funded by the Foreign, Commonwealth & Development Office (FCDO) and its predecessor, United Kingdom Department for International Development (DFID), for the provision of technical assistance funds to support the due diligence process.

In March 2022, the Asian Development Bank (ADB) announced a $15 million equity investment in TAFF2 to support sustainable forestry practices in Southeast Asia and reduce logging in natural tropical forests by helping sustainably managed plantation companies to scale up their operations. The investment comprised $5 million from ADB's ordinary capital resources and $10 million from the Australian Climate Finance Partnership (ACFP) trust fund. ACFP is a concessional blended financing facility managed by ADB and funded by the Government of Australia through the Department of Foreign Affairs and Trade (DFAT). ACFP seeks to catalyze financing for private sector climate adaptation and mitigation investments in the Pacific and Southeast Asia, and address market gaps and demand by de-risking high development impact projects and bringing them to market. There is a need for more capital that incentivizes the protection of forests, and DFAT, through its investment, aims to play a catalytic role in crowding in more investors into the transaction.

The David and Lucile Packard Foundation, DFAT, and a third investor capitalized the impact tranche of the fund, solidifying the Fund's capital structure to mobilize funds from commercial investors.

In addition to the David and Lucile Packard Foundation and ADB, additional investors including TotalEnergies, Sumitomo Mitsui Trust Bank and Temasek (GenZero) also made commitments to the Fund's Class A tier in March 2022, allowing New Forests to announce the first close with capital commitments of $120 million.

Following the first close, another two investors joined the Fund in October 2022, including the Hempel Foundation. The investment was a timely fit for the Copenhagen-based Foundation, who had recently launched an impact investment initiative for biodiversity (Biodiversity Impact Investment Initiative). Moreover, the participation of other credible investors made the TAFF2 opportunity an attractive investment proposition. Hempel subsequently invested in TAFF2's commercial tranche. This was one of the first two investments which Hempel Foundation made.

TAFF2 aims to capitalize on the long-term investment opportunities in sustainable plantation forestry and nature-based solutions investments in Southeast Asia. The Fund also continues to attract interest from institutional investors who are currently carrying out due diligence for investment.

Key Transactional Risks

TAFF2 must navigate the following risks associated with forestry and target regions for the Fund:

i. Operational risk – New Forests' operations are based on environmental and social standards that are different from the norm in Southeast Asian countries. In most countries in the region, the government is the largest (if not the only) owner of forest land (except in Papua New Guinea where local communities own 97% of the forests). The forestry sector within the region has therefore historically been characterized by concessions for logging natural tropical forests or establishing agricultural plantations. The low capital cost of entry to the industry meant favorable returns were possible without carrying out sustainable operations. New Forests' TAFF2 seeks to make sustainable investments aligned to high ESG standards which would limit deforestation. As such, these standards are in contrast with the legal rights of the forestry sector in Southeast Asia. The Fund therefore needed to secure a pool of capital that would be focused on Impact Activities as well as reduce the perceived risk of investing in such transactions to match expected market returns and crowd in purely commercial investors that would not traditionally invest in impact-linked projects.

ii. High perceived risk by institutional investors due to limited knowledge of the sector – Private investors, especially institutional investors, have shown limited participation in investments in sustainable forestry. New Forests, therefore, had to demystify the sector and its dynamics as it reached out to potential investors while fundraising to ensure that the risks and opportunities involved in the forestry and natural resources asset class were better understood, which drew in some investors to make informed decisions. The participation of some notable investors with experience in the sector also provided a signaling effect that drew investors into the transaction.

iii. Greenfield and early brownfield assets requiring upfront capex and continued operational expenses – To navigate this, New Forests identified a need to set up a larger second fund than its first when setting up TAFF2 given the associated high initial capex costs in the forestry sector. New Forests also identified an opportunity to invest in more established and mature plantations and to target an earlier positive cash flow such as carbon credits from new establishment of plantings.

Capital Structure

New Forests' TAFF2 has a blended finance capital structure with a target size of $300 million in investments. TAFF2 is the first sustainable forestry fund in the region with a blended capital structure with commercial and impact investor assuming risk *pari passu*, with different rates of financial return.

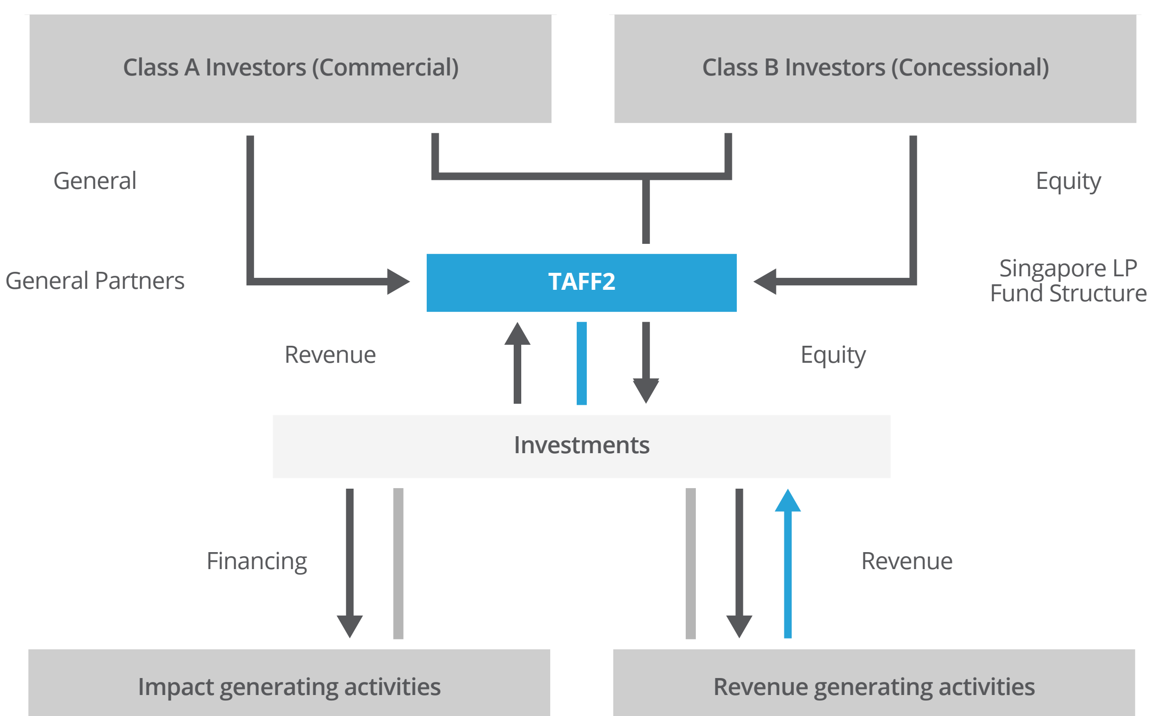
The Fund has two tranches that investors can participate in – Class A shares and Class B shares. The Class A tranche targets commercial forestry returns which are commensurate with market expectations that would range between the mid and high teens. Class A investors are expected to provide approximately 80% of TAFF2's capital (~$250 million).

Class B on the other hand is a concessional impact investment tranche with a target size of $50 million. The tranche will accept a lower target financial return than Class A shares and a lower share of distribution in recognition of investment by the Fund into Impact Activities. The structure allows for the Fund manager to spend an amount equivalent to 50% of the Class B capital commitments on Impact Activities during the life of the Fund, with climate mitigation being a primary focus. Impact Activities include forest protection, habitat enhancement and revegetation, community development training programs and enhanced benefit sharing schemes.

Target returns for Class B investors are in the mid-high single digits. Given that the Impact Activities are likely non-revenue generating, Class B investors will forgo a proportion of their cash distributions (repayment) in excess of their capital return that would be payable to them if distributions were on a *pari passu* basis. Through this blended structure, Class B investors will catalyse a greater scale of impact investment into TAFF2 sustainable plantation forestry and conservation nature-based solutions assets.

The blended structure seeks to moderate the overall risk-return profile of the Fund to mobilize investments into high impact forestry and nature-based solutions projects, targeting climate, community, and biodiversity benefits while also meeting investor objectives.

TAFF2 aims to capitalize on the long-term investment opportunities in sustainable plantation forestry and nature-based solutions in Southeast Asia. As such, the Fund continues to attract strong interest from investors who are currently carrying out their due diligence. New Forests is anticipating a final close around end of 2023 / early 2024.



RETURNS

Fund's net internal rate of return (IRR) is expected to be mostly driven by investment in sustainable timber production, particularly of higher value end products, such as furniture and flooring, and improved forest management, governance, timber marketing and processing.

The sale of carbon credits is also expected to contribute to the Fund's financial returns. The Fund estimates that it will generate in excess of 10 million tons of carbon credits over the life of the Fund, given that part of the Fund's mandate is to implement one or two REDD+[1] or conservation nature-based solutions projects.

DISTRIBUTIONS TO INVESTORS

Distributions from TAFF2 are allocated to investors and the Fund manager through a differentiated distribution waterfall as outlined below:

A Capital Return

First, the Limited Partners will receive prior distributions and proceeds equal in aggregate to their capital contributions at the time of calculation.

B 2% Preferred Return

Of the balance, 100% will be allocated to the Limited Partners until the cumulative distributions equals a 2% per annum compounded IRR.

C Class A Preferred Return

Thereafter, of the balance of returns, 100% to the Class A Limited Partners until the cumulative distributions to the Class A Limited Partners of Prior Distributions and Proceeds (including for clarity, the 2% Preferred Return), equal a 10% per annum compounded IRR (the amount of cumulative distributions required to provide such IRR, the "Class A Preferred Return") on the Class A Limited Partners' Capital Contributions.

D GP Catch-up

Fourth, 100% to the General Partner as a Performance Fee until the General Partner has been paid Prior Distributions and Proceeds equal to 20% of the amounts paid under paragraphs (B) ("2% Preferred Return") and (C) ("Class A Preferred Return") (any distributions to Class A Limited Partners in respect of their 2% Preferred Return will not be counted twice) and this paragraph (D) ("GP Catch-up").

E 80/20 split

Thereafter, 80% would go to the Class A and Limited Partners and 20% to the General Partner as a performance fee. These distributions are otherwise attributable to the Class B Limited Partners, if the cumulative distributions to the Class A Limited Partners under items (A) to (E) above are:

- less than 20% per annum compounded IRR on the Class A Limited Partners' Capital Contributions, 75% of such distributions will be allocated to the Class A Limited Partners and the remaining 25% will be allocated to the Class B Limited Partners;
- equal to or greater than 20% but less than 25% per annum compounded IRR on the Class A Limited Partners' Capital Contributions, 50% of such distributions will be allocated to the Class A Limited Partners and the other 50% of the distributions will be allocated to the Class B Limited Partners; or
- equal to or greater than 25% per annum compounded IRR on the Class A Limited Partners' Capital Contributions, 100% of the distributions will be allocated to the Class B Limited Partners.

1 REDD+ is a framework created by the United Nations Framework Convention on Climate Change (UNFCCC) Conference of the Parties (COP) to guide activities in the forest sector that reduces emissions from deforestation and forest degradation, as well as the sustainable management of forests and the conservation and enhancement of forest carbon stocks in developing countries.

Operations

INVESTMENT CRITERIA

TAFF2 will invest primarily in high-quality sustainable plantation forestry and conservation nature-based solutions assets in Southeast Asia mainly through acquiring, establishing, and sustainably managing these projects. Since its establishment in 2008 in Southeast Asia, New Forests has built a solid pipeline list over the years with several assets being ready for advanced late-stage due diligence to proceed into deployment.

TAFF2 investments will target climate adaptation as well as climate mitigation. Opportunities will be sought in Cambodia, Indonesia, Laos, Malaysia, Thailand, and Vietnam.

New Forests' investment strategy has a mixed landscape approach that focuses on integrating the different land-uses on a single concession investment to include plantations, infrastructure, conservation nature-based solutions, and social engagement with local communities. The mixed landscape approach is designed to optimize the utilization of the landscape and to optimize financial returns and impact outcomes.

New Forests will align investment activities with the interests of local communities. Please see the section on Impact Activities for a more detailed description.

INVESTMENT PROCESS

New Forests' TAFF2 currently has more than 100 deals in its pipeline, with several deals in late-stage due diligence. New Forests expects to deploy the majority of the Fund's capital in Malaysia, Indonesia, Vietnam, Laos, and Cambodia.

New Forests seeks to embed ESG, business integrity and impact considerations at all stages of the investment process.

Transaction Origination and Screening

- High-level review of compatibility with ESG requirements of fund
- Embed ESG in term sheets
- Pipeline management includes ESG and Impact characteristics, including carbon opportunities

Initial Due Diligence

- Assessment of "plantable area" considering E&S requirements
- Assessment of E&S risks, e.g. FPIC and land claims, forest conversion
- Review of potential compliance issues with E&S Policy
- Further refine carbon opportunities assessment

Due Diligence

- Third-party FSC and IFC PS gap analyses
- Business integrity/risk checks and third-party screening
- Exploration of ESG alignment with JV partners, as relevant
- Identification and evaluation of potential Impact Activities

Negotiation

- Formulate Environmental & Social Action Plan (ESAP)
- Embed ESG requirements in transaction documents
- Embed Impact Activities in transaction documents, where possible
- Secure environmental credit rights, as needed

Investment Committee

- Investment Recommendations will include material ESG risks, opportunities, and conformance with E&S Policy
- Investment Recommendations will include results of preliminary Impact Activities eligibility and potential
- Sign off by Internal ESG reviewer

100-Day Plan

- Address significant ESG risks
- Ensure sustainability resourcing in portfolio company
- Work with management team for onboarding into TAFF2 ESG and Impact processes
- Begin compliance process for E&S Policy, including developing ESAP
- Conduct gap analysis for Environmental and Social Management System, initiated planning
- Begin elaboration of Impact Activity project plans

Active Management

- TAFF2 E&S Manager acts as capacity development resource and provides oversight
- ESG and impact reporting integrated into operations reporting
- Achieve compliance with E&S Policy
- Manage and report on Impact Activities, incl. carbon
- ESG compliance monitored

Exit

- Include ESG and Impact credentials and outcomes in marketing materials for sales process
- Conduct ESG review of potential buyers for inclusion in disposition papers

Source: New Forests

Impact

New Forests' TAFF 2 seeks to build on New Forests' track record and leverage their 15 years of experience working in the region and in sustainable forestry by embedding impact management through the Fund's strategy, investment process, and active asset management as well as by applying proven impact models across its portfolio. New Forests has attracted multiple accolades for its TAFF2 fund. For example, in September 2021, TAFF2 was awarded the Financial Investigator Impact Investing Award for Private Funds, and in May 2023, New Forests won the Best Impact Investment Adviser by Asian Investor.

Leveraging the advantage of blended finance, TAFF2 plans to integrate and undertake Impact Activities that aim to deliver climate, biodiversity, and livelihoods benefits that are aligned with the Sustainable Development Goals (SDGs) – especially SDGs 8: Decent Work and Economic Growth, 13: Climate Action, and 15: Life on Land.

New Forests will identify Impact Activities as part of due diligence, seeking to embed impact management within the commercial investment approach of the Fund, with at least 50% of impact funding intended to go towards the Impact Activities targeting Climate-focused Impact. A few sample Impact Activities identified by the Fund are outlined below:

Climate-focused Impact Activities

- Improved forest management contributing to reduced emissions from natural logging and/or increased carbon stocks;
- Afforestation, reforestation and revegetation to increase vegetative cover through human assisted natural regeneration processes;
- Avoiding planned or unplanned deforestation and/ or degradation;
- Peatland restoration/rewetting for reduced microbial decomposition;
- Wetland protection and restoration especially for mangroves, tidal and coastal wetlands, marshes, seagrasses, floodplains, and deltas; and
- Village forests projects to support community managed lands and out grower projects for carbon

Biodiversity-enhancing Impact Activities

- Habitat restoration for key flora/fauna species;
- Riparian zone restoration aimed at restoring and enhancing hydrological values;
- Conservation corridors to restore and conserve areas linking various conservation areas;
- Activities specifically geared around the conservation of rare and endangered species or culturally significant sites; and
- Harvest regime optimization for biodiversity

Community and livelihoods focused Impact Activities

The Fund's Impact Activities for communities and livelihoods include measures to both involve the local community in conservation and responsible management exercises, as well as create shared benefit opportunities and build capacity. These activities include supporting smallholder farmers to achieve compliance with Forest Stewardship Council (FSC) standards, introducing community-based monitoring utilizing performance-based reward systems, creating value through outgrower schemes, community joint ventures and agroforestry/agricultural extension projects and helping build skills and capacity among local contractors.

TAFF 2 aims to report to investors on its plans and progress on Impact Activities on a regular basis. New Forests has developed and applies its Sustainable Landscape Investment framework to TAFF2 that includes a corporate sustainability framework, a tailored Environmental & Social Policy, and a dedicated team of professionals committed to enhancing investment performance through Sustainable Landscape Investment. The Fund will also apply the IFC Performance Standards to all investments as well as the Forest Stewardship Council Forest management certification standard where it can be achieved.

Key Insights

i Creating solutions that involve the community is important in supporting successful execution and creation of impact.

New Forests acknowledges that many local Southeast Asian countries have regulations that allow for deforestation for economic activities. It is therefore important to provide alternative sources of livelihood for communities to reduce logging and unsustainable forest land use. TAFF2 involves the community to create a shared interest between the Fund and the people living in and around concession areas in achieving conservation and climate objectives. Through community partnerships, New Forests is also able to address land tenure claims to acquire social licenses to operate and access land.

ii Technical assistance grant funding plays a key role in supporting pipeline development and reducing upfront costs.

Technical assistance funds provided by Restoration Seed Capital Seed Facility, Green Invest Asia and Partnerships for Forests for pre-due diligence and due diligence helped reduce the high costs New Forests experienced when managing TAFF. Technical assistance can thus play a key role in increasing the financial feasibility of a Fund's underlying investments.

iii Blended finance structures can be used to create financial returns alongside more impact.

TAFF2 includes a concessional tranche to mobilize high impact forestry and nature-based solutions investments targeting climate, community, and biodiversity benefits. Through blended finance, TAFF2 can participate in impact creation activities that may have lower expected returns financial return target, but which promote high sustainability and climate benefits and ensure a conducive environment for the creation of both impact and financial return.

iv There is increasing appetite from local and international commercial investors for investing in forestry in the region and beyond.

With the increased global focus on climate, mitigation and adaptation, more organizations and corporates are entering into voluntary net zero goals and targets. TAFF2 drew in investors such as Hempel Foundation who had traditionally not invested in the sector before but found comfort in New Forests' track record, their investor base and appreciated the impact the Fund aimed to create as enabled by the structure and foresee this as an opportunity to make a case for similar investments in future.

v Investment readiness can play a role in increasing the odds and flow of successful outcomes.

Pipeline development is a resource and time intensive endeavor. Through experience, New Forests acknowledges the need to continually build a pipeline of investment opportunities available for funding well in advance of fundraising efforts. This makes the process of identifying aligned investments and disbursing funds less costly and increases the chances of successful outcomes.

CONVERGENCE
BLENDING GLOBAL FINANCE

CONVERGENCE is the global network for blended finance. We generate blended finance data, intelligence, and deal flow to increase private sector investment in developing countries.

BLENDED FINANCE uses catalytic capital from public or philanthropic sources to scale up private sector investment in emerging markets to realize the SDGs.

Our **GLOBAL MEMBERSHIP** includes public, private, and philanthropic investors as well as sponsors of transactions and funds. We offer this community a curated, online platform to connect with each other on blended finance transactions in progress, as well as exclusive access to original market intelligence and knowledge products such as case studies, reports, trainings, and webinars. To accelerate advances in the field, Convergence also provides grants for the design of vehicles that could attract private capital to global development at scale.