

# Natural capital – rebirth of an asset class

✓ **Dr Michael A. Ridley highlights the important role of natural capital in reducing CO<sub>2</sub> emissions and the benefits it can provide for investors**

The UK recently joined the ranks of governments around the world issuing green bonds. The result was record demand, with investors willing to pay a premium for the bonds which will fund projects related to carbon capture and storage, for instance. Of course, there is already someone with a tried and tested approach to carbon sequestration – mother nature herself. Per the chart below, nature's assets absorb

over 40 per cent of carbon emissions.

Yet investors and policy makers are only beginning to recognise the economic value of nature's assets, or natural capital. Beyond proving its worth in carbon sequestration, natural capital delivers an array of essential services to mankind intertwined through a delicate balance of biodiversity. Unfortunately, the rapid economic growth achieved over the past decades that has lifted

several billion people out of poverty, has also promulgated two environmental catastrophes – rapid climate change and the widespread loss and destruction of biodiversity.

The financial world has paid some attention to climate change, at times with no choice as the impacts of extreme weather events become increasingly felt. However, until recently the issue of biodiversity was largely ignored. This is despite the fact that biodiversity loss and climate change compound each other. Deforestation and soil tilling is responsible for almost a fifth of carbon dioxide emissions itself, a share greater than transport<sup>1</sup>. And climate change causes biodiversity loss – as temperatures rise and deserts advance, species decline and we lose biodiversity.<sup>2</sup>

## Scale and drivers of the threat to natural capital

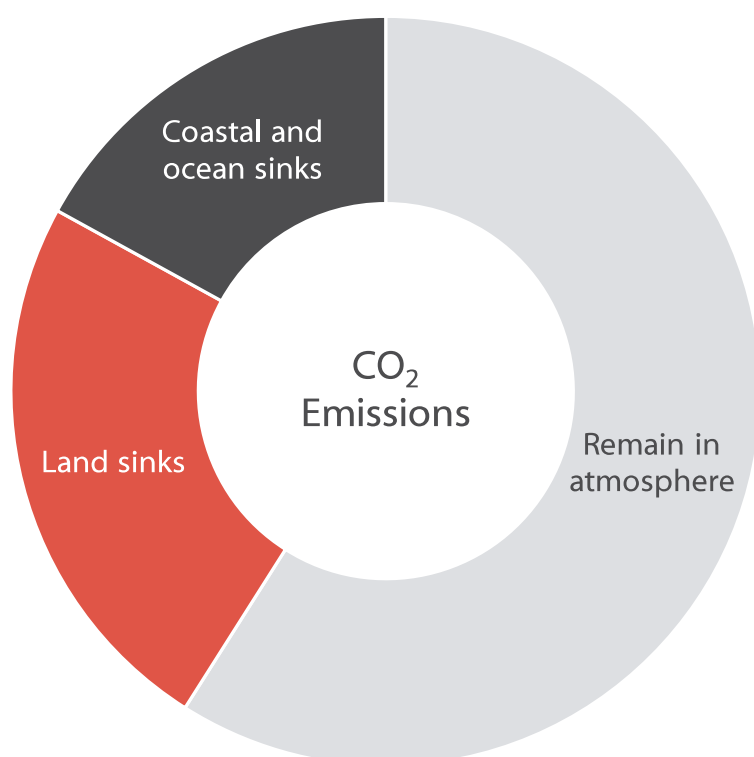
Potential economic ramifications are harrowing. The World Economic Forum estimates over \$40 trillion of economic value generation, more than half the world's output, is moderately to highly dependent on nature<sup>3</sup>. Yet around a fifth of countries are at risk of their ecosystems collapsing<sup>4</sup>.

Cambridge economist, Partha Dasgupta, recently argued that we are losing natural capital because we do not assign a value to the services it provides<sup>5</sup>. In fact, Dasgupta describes natural capital loss as an 'asset management problem'. We agree.

One reason for the mispricing of natural capital is that biodiversity can offer little direct economic benefit to the local landowner. For example, it is typically worth more to a farmer to cut down trees than to keep a forest in the ground. To address this conflict, we need a system that values the ecological services the forest provides and aligns the incentive of the farmer with that of the public.

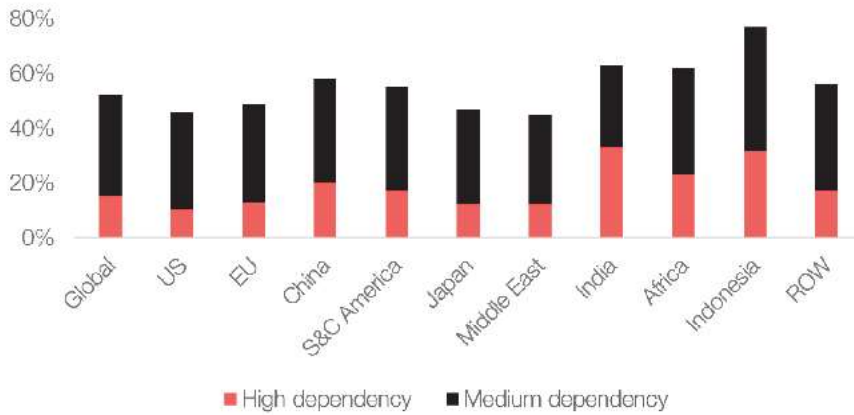
This is an immediate need. An estimated \$8 trillion of investment in

## Natural carbon 'sinks' absorb much of our CO<sub>2</sub> emissions



Source: Project Drawdown, IPCC & Global Carbon Project (2020)

## Output dependency on nature



Source: World Economic Forum (January 2020)

nature is required between now and 2050 to tackle the interlinked climate, biodiversity, and land degradation crises. Today’s roughly \$130 billion per annum invested in nature based solutions will have to triple by 2030, and rise four-fold by 2050.<sup>6</sup>

### Contributing to the solution and generating returns

We believe the cards are falling into place for the emergence of natural capital as an asset class. Metrics are being developed to measure biodiversity. Asset owners are learning to ‘stack’ multitudinous cash flows from natural capital assets. Firms and countries that have made net-zero commitments are ready buyers of nature based solutions, in the form of carbon offsets. Biodiversity offset markets are developing. Governments and investors are awakening to the fact that protecting natural capital helps slow climate change by trapping carbon in trees and soil.

Increasing investor demand for assets that stand to grow in importance and value as the world tackles climate change

and broader sustainability challenges is also a driver. Accordingly, we see increasing financial flows being directed to boost natural capital and preserve the ecosystem services it provides. Growing carbon permit regimes represent a significant part of the solution in assigning value to the services of natural capital. Encouragingly, biodiversity permits are being trialled in Australia and the UK.

Even in the absence of such solutions, preserving and restoring natural capital can already provide financial gains. Switching from industrialised agriculture to restorative farming and from intensive forestry to more sustainable forestry methods serve as examples. Such changes can deliver a new and broader set of cashflows, with greater resiliency. This is due to the higher value being placed on sustainable agriculture and wood products by consumers, ancillary revenue streams such as tourism, savings on pesticides and fertiliser, along with potential land price appreciation due to the mounting scarcity value of natural

capital and rising demand for this emerging asset class.

Moreover, we would argue that such benefits today should increase significantly in future. We expect more carbon and biodiversity regimes to be rolled out internationally and for carbon and biodiversity permits to possess significant value. Even if permits are not available, we feel that demand for natural capital will grow, and that it can be purchased at reasonable prices today.

Transformation in how we value natural capital will not only be driven by innovative landowners, or investors looking for impact. Pending reporting and disclosure requirements plus regulatory pressures will help drive this. The EU and UK, for instance, have already initiated steps to implement legally-binding measures supporting biodiversity and ecosystems.

In our view, natural capital investments can provide a trio of benefits – a significant yield, positive impact in terms of enhanced ecosystem services, and asset appreciation. Furthermore, they will serve as a hedge to investors and businesses exposed to carbon intensive portfolios. There is a clear long-term investment opportunity to go alongside the societal need. Crucially, asset managers will need to deliver the solutions that allow investors to appropriately allocate their capital towards nature.



**Written by HSBC Asset Management, director, senior responsible investment specialist, Dr Michael A. Ridley**

In association with



<sup>1</sup> *The Economics of Ecosystems and Biodiversity; Responding to the Value of Nature, 2009*

<sup>2</sup> *A study published in Biological Conservation found that a third of species on land and half in the sea will become extinct if greenhouse gas emissions are not reined in: ‘Current emissions put the world on track for biodiversity collapse’, Bloomberg Green, 8 April 2021.*

<sup>3</sup> *‘New Nature Economy Report – Nature Risk Rising’, World Economic Forum, (January 2020)*

<sup>4</sup> *‘Biodiversity and Ecosystem Services: A business case for re/insurance’, Swiss Re, (September 2020)*

<sup>5</sup> *‘The Economics of Biodiversity: The Dasgupta Review’, HM Treasury (February 2021)*

<sup>6</sup> *‘State of Finance for Nature’, UNEP, WEF, Economics of Land Degradation Initiative, Vivid Economics (May 2021)*