



Natural Capital Report 2024.

A PARTNERSHIP BETWEEN:



Gresham House
Specialist investment

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WELCOME!

The depletion and damage to global natural resources are fast translating to financial risks. Nature has subsidised economic growth to its serious detriment, creating another existential threat inextricably linked with climate change.

As a result, investors are turning their attention to natural capital. New regulation has led to the establishment and evolution of new nature markets and the introduction of voluntary frameworks which place a value on nature. Natural capital is no longer an abstract environmental concept; it is a tangible asset class.

To better understand how natural capital can fit within asset allocation processes, how it can help investors achieve their ESG objectives, and what challenges they face when investing in natural capital, **mallowstreet**, in partnership with **Gresham House**, surveyed 22 UK institutional asset owners in March 2024, gathering perspectives on a total of £360bn in assets under management.

This report presents our in-depth findings. We hope you find it insightful.

TABLE OF CONTENTS:

EXECUTIVE SUMMARY & INDUSTRY RECOMMENDATIONS (p. 3)
GENUINE INTEREST TO SUPPORT CLIMATE ADAPTATION (p. 4)
NATURAL CAPITAL AS A THEME GATHERING MOMENTUM (p. 5)
GENERATING CREDITS INSTEAD OF BUYING THEM (p. 6)
ASSET MANAGERS TO LEAD THE WAY (p. 7)
CONCLUSION & NEXT STEPS (p. 8)



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KEY STATISTICS

22

trustees, pension heads and
investment decision-makers

100%

UK-based asset owners

£360bn+

of institutional assets
represented

12

LGPS schemes

5

large DB schemes

5

insurance firms

12

questions

500+

primary data points

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EXECUTIVE SUMMARY

THERE IS GENUINE INTEREST TO SUPPORT CLIMATE ADAPTATION VIA NATURAL CAPITAL: despite it being a nascent investment, UK institutional investors see natural capital as an important way to aid climate change mitigation, alongside making a return. However, they seem less interested in targeting specific impact, e.g., to enhance biodiversity, minimise nature damage or support the production of sustainable resources. As a result, many will take a broader stewardship approach. All this shows a disconnect which needs to be addressed: climate adaptation cannot happen without restoring nature.

HALF OF UK ASSET OWNERS ARE ALREADY INVESTING or planning to invest in natural capital within the next 18 months. Allocations will start off small, most likely around 3%. Natural capital will sit within either real assets or growth assets – depending on this, the ideal solution will look different. There are signs that LGPS schemes may be more receptive to less liquid strategies that go beyond just risk management and engagement and offer direct, real exposure to natural capital. Growth asset investors may prefer thematic portfolios and nature-positive stewardship.

ACROSS THE BOARD, INVESTORS PREFER GENERATING VOLUNTARY CREDITS to offset the emissions and nature loss in their portfolios, and some hope to realise a return upon selling them. However, there is limited interest in purchasing voluntary credits in the open market. Investors feel that more rigour and standardisation are needed to make them more comfortable with the voluntary credits market.

ASSET MANAGERS SHOULD LEAD THE WAY IN NATURAL CAPITAL: in such a new market, there is no rule book yet, and many investors will let their managers decide on the most important themes where natural capital investments can lead to positive impact. There is appetite for doing so globally, as well as within the UK specifically. But with few existing leaders, the natural capital solutions market is ripe for further collaborative development to create best practices.

INDUSTRY RECOMMENDATIONS

- Invest in natural capital to support climate adaptation and generate offsets for emissions and nature loss in your portfolio
- Consider nature restoration and stopping biodiversity loss in the context of the climate transition – they are crucial
- Increase focus on themes such as sustainable agriculture and land use, sustainable urban infrastructure, and afforestation
- Anchor the case for natural capital to an allocation of 3%-5% of the total investment portfolio
- Understand the risk-return profile of different solutions, specifically the illiquidity risks, capital seniority and return premia
- Speak with peers and solution providers to gather different perspectives on how to approach natural capital
- If you have a real assets portfolio, approach natural capital as a direct and semi-illiquid investment in a real asset
- If you have a growth assets portfolio, consider nature as a topic for engagement and risk integration across the portfolio

KEY STATISTICS

73%

of UK asset owners would invest in natural capital to support climate adaptation

86%

would accept a net return of 8% for a UK natural capital real asset fund

50%

are either already investing in natural capital or will do so within the next 18 months

59%

will allocate around 3% of their total assets

52%

prefer to generate voluntary carbon and/or biodiversity credits themselves, in order to offset emissions or nature loss in their portfolio

* Throughout this report, figures may add up to 99% or 101% due to rounding of percentages. Additionally, some questions required multiple answers, so figures in some bar charts will add up to significantly more than 100%. In such charts, dark blue highlights may be used to emphasise key statistics and help the reader follow the analysis.

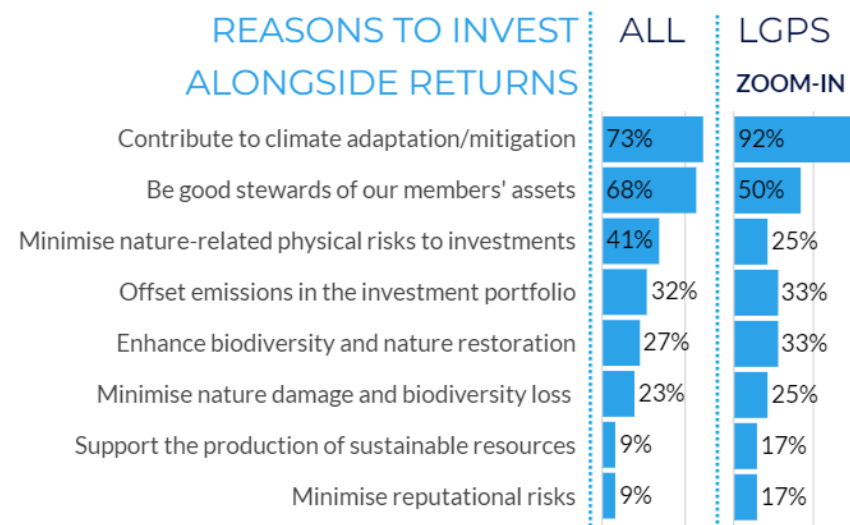
THERE IS GENUINE INTEREST TO SUPPORT CLIMATE ADAPTATION

UK institutional investors see natural capital as an important way to aid climate mitigation, alongside making a return – but will take a broader stewardship approach rather than targeting specific impact.

Investing in nature seems to co-exist quite comfortably with a return goal: 86% of UK institutional asset owners say they find a net return of 8% acceptable for a UK natural capital real asset fund. However, the risk profile of such investments is an important consideration, including illiquidity risk and position in the capital structure.

Alongside returns, 73% of institutional asset owners in the UK say the top reason they would invest in natural capital, if they do not do so already, would be to contribute to climate adaptation and mitigation. This is even more important to LGPS schemes, as 92% prioritise climate adaptation. At the same time, only a third are specifically looking to offset emissions in their investment portfolio. This suggests a genuine interest to mitigate climate change and support climate adaptation, beyond decarbonising assets.

However, only around a quarter are explicitly interested in enhancing biodiversity and nature restoration, or minimising nature damage and biodiversity loss. Even fewer wish to support the production of sustainable resources. This is an interesting disconnect, given that climate adaptation relies on both restoring nature and stopping further damage.



Instead, 68% of UK institutional investors say they would invest in natural capital to be good stewards of their members' and policyholders' assets.

In this context, asset managers may wish to approach natural capital with an engagement mindset and demonstrate an ability to minimise nature-related risks – which is the third most popular reason to consider such investments for 41% of all investors.

However, many managers focus on ecosystem services when discussing natural capital, the value they have, the impact on GDP, and the risks that biodiversity and nature loss poses.



KEY STATISTICS

86%

of all UK asset owners would accept a net return of 8% for a UK natural capital real asset fund

92%

of LGPS schemes would invest in natural capital to support climate adaptation

68%

of all investors would do so to be good stewards of their members' assets

32%

are looking to offset emissions in their investment portfolio

27%

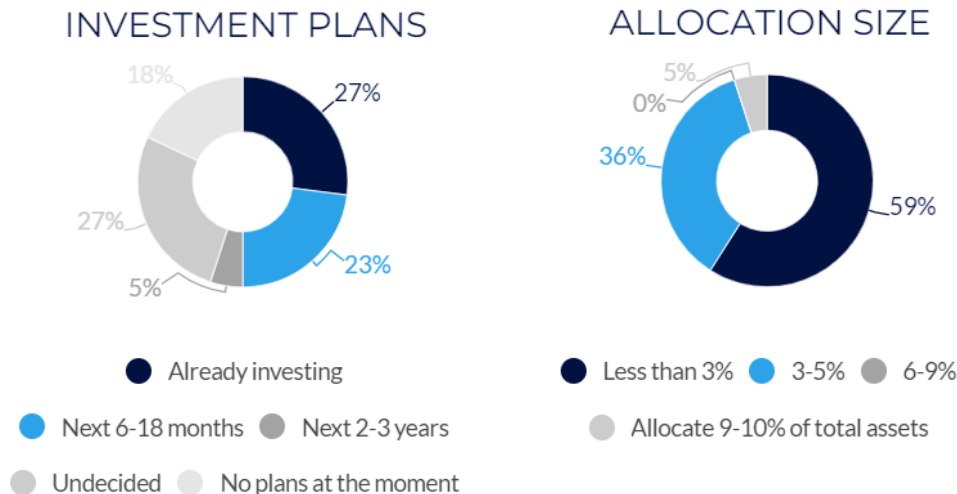
or fewer are interested in nature restoration, stopping biodiversity loss or improving resource production

NATURAL CAPITAL IS A NASCENT THEME GATHERING MOMENTUM

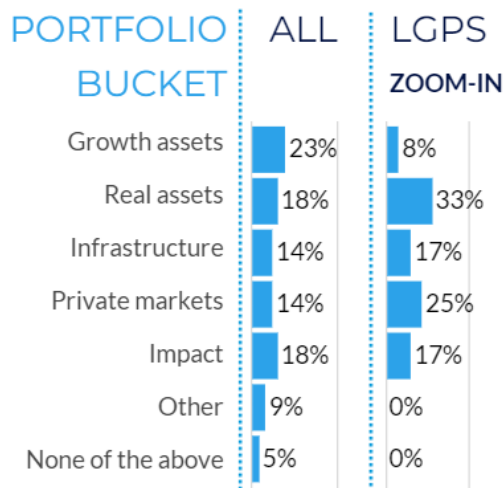
UK asset owners are planning to invest in natural capital – allocations will start off small, but there is room within both illiquid and growth assets.

Half of UK asset owners are either already investing in natural capital or plan to make an allocation in the next 18 months. And while many are still undecided, just one in five say they do not plan to invest in such opportunities. This shows momentum is building in this new investment theme.

Allocations to natural capital are likely to comprise 3% to 5% of total assets: just over half say that they would invest less than 3%, while an additional third see themselves potentially investing up to 5%.



LGPS schemes typically invest in natural capital via illiquid assets: 33% take a real assets approach, and an additional 25% invest via private markets. This is another reason why they may be interested in more sophisticated illiquid investment strategies which offer direct exposure to natural capital as a real asset rather than as a philosophy across the entire portfolio.



Amongst other asset owners, natural capital is broadly seen as a real growth asset: 23% of UK investors would allocate to natural capital via that portfolio, while 18% have an impact allocation. A handful have another approach via a diversified alternative assets portfolio.

Interestingly, allocating to natural capital via growth assets is another possible reason why many investors plan to take a stewardship approach to nature-related risks (see previous page). Growth asset portfolios often include allocations to liquid assets, including equities. To apply a natural capital lens to such investments, investors can mainly rely on risk integration and engagement with the underlying companies, which are the primary ways to be a good steward of one's assets. An alternative would be thematic portfolios and tilts.

KEY STATISTICS

50%

of UK institutional investors are either already investing in natural capital or will do so within the next 18 months

59%

will allocate around 3% of their total assets

36%

may invest up to 5% in natural capital

33%

of LGPS schemes would invest via real assets

25%

of them would invest via private markets

23%

of all investors put natural capital in their growth assets

GENERATING CREDITS IS PREFERABLE TO BUYING THEM

There is limited interest in purchasing voluntary credits to offset the emissions and nature loss in investor portfolios – they prefer offsetting with credits they generate themselves, and even sell some for a return.

Nearly all institutional investors prefer generating voluntary carbon and/or biodiversity credits from their investments. About half would use them to offset nature loss and emissions in their own portfolios, while the rest will sell their credits to generate an additional return. This suggests the focus is on genuinely supporting climate adaptation and mitigation.

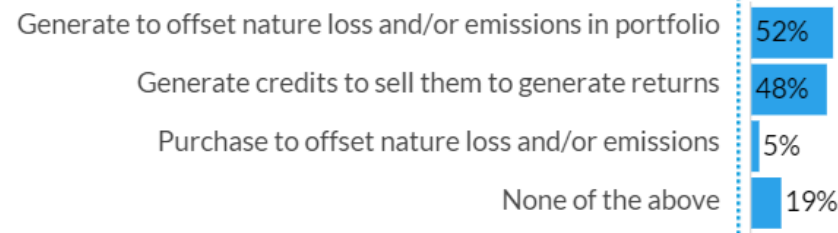
However, there are concerns about the market for voluntary credits. In fact, purchasing credits in the open market to offset any nature loss or emissions elsewhere in the investment portfolio is of interest for only 5% of institutional asset owners.

Concerns around buying credits could be linked to lack of confidence in the quality of credits and/or lack of additionality, while generating credits directly offers investors comfort around the project type. To properly consider trading in the voluntary credits market, investors would like to see the following:

- A deeper, more formal international market with a proven track record and clear purpose, which is unbiased towards sectors or jurisdictions and does not risk credits lapsing
- Consistent global standards in rigorous transparent credit calculation, impact measurement and ratification
- Categorical proof that the credits are making a real impact and bringing change, and not simply greenwashing via financial engineering or continuing the status quo for fossil fuels

The Science-Based Targets Initiative (SBTi) recently revised its guidance to allow the use of 'environmental attribute certificates' including carbon credits to offset Scope 3 emissions beyond previous limitations. While this is not a mandatory standard and the SBTi will not engage in validating the quality of the offsets, this development will likely prompt many to reconsider how they obtain and use carbon and/or biodiversity credits. As a result, the voluntary market will keep evolving.

PURPOSE AND ROLE OF VOLUNTARY CREDITS



KEY STATISTICS

52%

prefer to generate voluntary carbon and/or biodiversity credits to offset emissions and/or nature loss elsewhere in their portfolio

5%

would purchase such credits in the open market

48%

would sell their voluntary carbon and/or biodiversity credits for a return

ASSET MANAGERS NEED TO LEAD THE WAY IN NATURAL CAPITAL

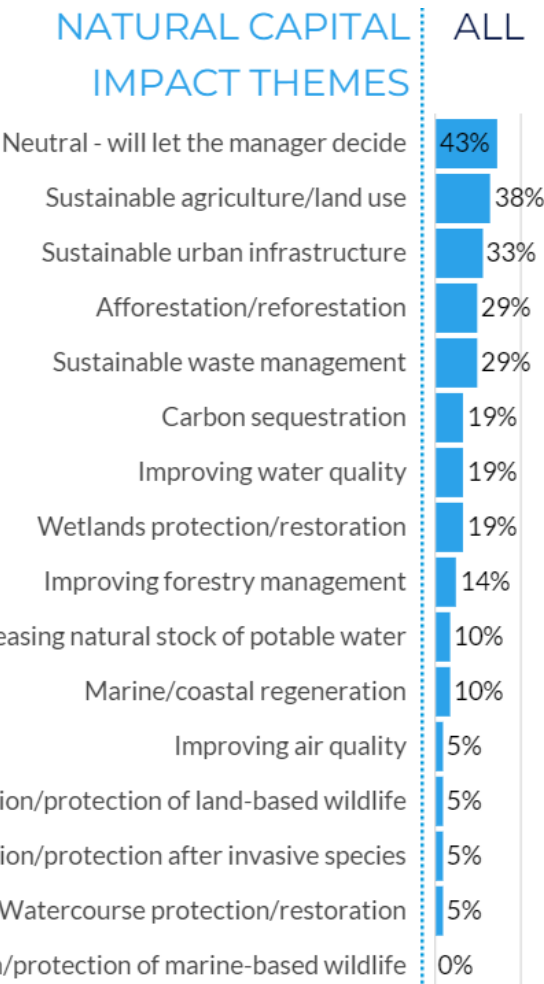
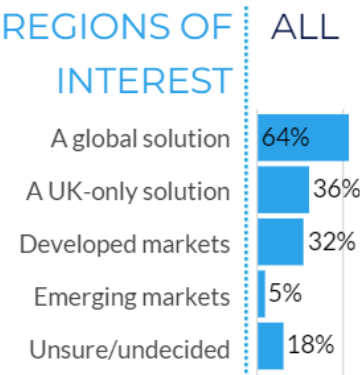
Investors will rely on their managers to decide on the areas where natural capital investments can lead to positive impact – and there is room to do so globally.

Given how new the topic of natural capital is, and the limited interest in making a positive impact on nature (see page 6), it is not surprising that 43% of UK asset owners are neutral on the themes they would like to invest in to make a positive impact. These investors will defer to their managers to pick the best opportunities that can also deliver a financial return.

Despite this, some favourites emerge. Sustainable agriculture (of interest for 38%), sustainable urban infrastructure (33%) and afforestation (29%) are of immediate interest, likely because investors may already be familiar with these themes via other liquid asset classes. Another familiar theme is sustainable commercial forestry, which is not covered in this research but nevertheless popular among natural capital investors.

Carbon sequestration does not feature highly on the list of impact themes, echoing concerns about using credits to offset emissions (see page 8) as well as the genuine desire to support climate adaptation and mitigation beyond financial engineering and greenwashing. Similarly, other restoration and regeneration themes are not very popular on a standalone basis, further reflecting the nascent nature of these themes as an investable asset class.

Given the level of scrutiny required to manage natural capital investments successfully, asset owners and managers may initially want to focus on the UK. However, when asked which regions they are looking at, two-thirds of UK investors would be interested in a global solution (see chart below). This would give managers the freedom to choose themes and regions to invest in.



KEY STATISTICS

43%

of UK institutional investors are neutral on natural capital themes and would let their manager decide on areas for positive impact

38%

favour sustainable agriculture and land use

33%

focus on sustainable urban infrastructure

29%

are looking at afforestation and/or sustainable waste management

19%

prioritise carbon sequestration, improving water quality or restoring wetlands

CONCLUSION: THERE ARE FEW NATURAL-BORN LEADERS IN NATURAL CAPITAL

With no rule book yet for this area of growing interest, the natural capital solutions market is ripe for further collaborative development and the creation of best practice.

Such a new market has a challenge to educate end investors on the breadth and depth of natural capital solutions. Competing definitions and investment approaches will emerge, which may confuse and alienate some institutional investors, and cause them to put natural capital in the 'too complex' bucket.

In these conversations, best practice will slowly emerge and become more established, leaving some managers out of line with them, and others leading the pack. The narrative and rule book for natural capital will need to keep evolving.

Voluntary markets will also undergo change and may see broader adoption, especially after the SBTi clarifies the extent to which voluntary credits can be used in carbon offsetting. However, rigour and standardisation are needed to make investors more comfortable with the voluntary credits market.

In terms of the perceived leaders in natural capital, only two asset managers receive recognition from a long list of market players. Over three-quarters of institutional asset owners see Gresham House as a leader in this space – and this includes 100% of the LGPS schemes which took part.

To support these developments, asset managers and owners need to purposefully work together, remain in active dialogue with regulators, and collaborate with end investors to continue the knowledge exchange and establishment of best practices.

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