Asset owners head back to the forest amid natural capital boom

L-R: Marina Wang, Mark Rogers, Aleks Vickovich, Julia Newbould, Nick White and Robert Edmond

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SAVE ARTICLE

For some institutional investors, agribusiness and forestry assets bring back memories of the global financial crisis. But looking at it today, the potential diversification and monetisation benefits, alongside widespread net zero commitments, merits another look at the developing asset class of "natural capital".

Reflecting on UniSuper's blockbuster investment in a 170,000-hectare forestry estate in Tasmania, the fund's senior investment analyst, Marina Wang, admits there was an element of luck. "We were in the right cycle of the market from the broad listed versus unlisted space," Wang told an *Investment Magazine* roundtable on natural capital, in partnership with nature-based asset manager New Forests.

"It was the right time, right opportunity for us with it being an off-market transaction outside of the conventional bidding process."

"What was really attractive to us is that these large forestry transactions rarely occur, and to us, they really offer very quality, risk adjusted returns for our members."

Last month, UniSuper acquired private forest management company Forico and the estate in Tasmania, as part of a consortium with two European pension funds, Pension Protection Fund from the UK and Dutch fund ABP.

The deal was a sign of Australian superannuation funds increasingly leading in new investment areas, on par with global giants. But it also represented perhaps a turning point in the local institutional market's attentiveness to the developing asset class known as "natural capital".

Mark Rogers

The category is best defined as land-based investments that produce renewable resources. But New Forests' chief executive Mark Rogers, a pioneer in natural capital, said there are many more possibilities beyond real estate and resources. For example, he points to "agritech" as another potentially lucrative asset within natural capital's realm.

"All of the investments in yield analysis, data analysis, fertiliser, as some examples, will be critical in that space – our ability to produce more of something from the same or even less land will be critical in our solutions."

REST's head of growth alternatives Marina Pasika said that the natural capital space is receiving an unprecedented level of attention right now. However, she asked why – if natural capital is truly an attractive diversifying exposure for the whole portfolio – institutional investors are just now jumping on the bandwagon.

"I think there's been a bit of FOMO," Rogers said.

"We've had many investors with us since we established our first ANZ fund 13 years ago, and now we've got almost $11 billion under management... Those investors who have been with us through that entire journey have made double digit returns, and not a lot of that is based on anything other than land and trees."

"However, we are now seeing a critical play around optimising the land and the potential for additional revenue streams."

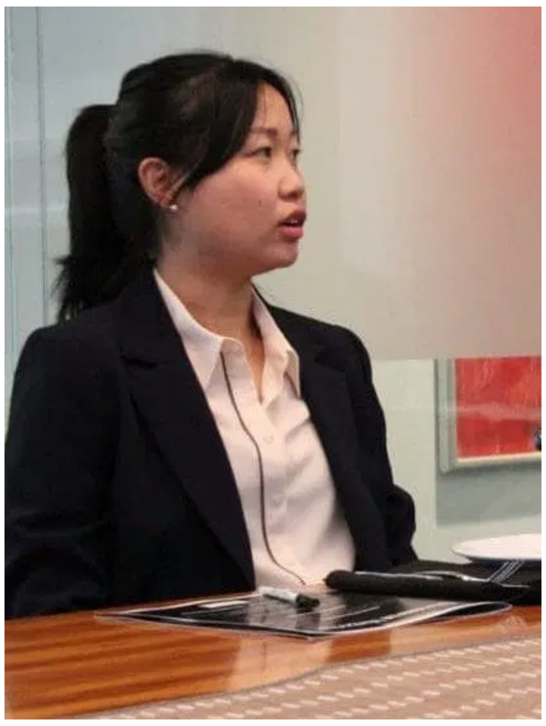
The asset class question

The broad definition of natural capital sparks a conversation around where it fits among the asset classes.

"The reason that asset classes exist and that most institutions think about the world in asset classes is because then you can define the expected return, the shape of that return and the characteristics that it has," REST's Pasika said.

"How we do that for something that's very broad and includes land and anything that adds value to that land, and then the tech as well?"

Associate director of investor relations at New Forests, Robert Edmond, explained the return of the company's natural capital assets is currently broken down in several ways: the tailwinds of forestry assets themselves, return of agriculture and infrastructure assets, and carbon as an optional extra.


Marina Wang

The company currently approaches asset owners with a local offering of five-seven per cent net of CPI and all fees and expenses, which is a nominal of 8-10 per cent, Edmond said. The US figure will be similar, but Southeast Asia can get up to 14-18 per cent (with attendant risks and differentiating factors).

UniSuper's Wang, meanwhile, didn't think the asset class question has a significant impact on the investment approach. She said that forestry is managed under the fund's private markets portfolio, which includes infrastructure, timberland and private equity.

However, she emphasised that because UniSuper doesn't have bucket allocations in its fund, forestry is treated just as another sector evaluated against the financial return to members.

"For forestry to compete against the allocation, it's really the entire allocation of the fund. So, it's not forestry against forestry transactions, it's forestry against airports, and against listed properties.

"We do view it [forestry] as a diversifier to our general infrastructure portfolio, and it has very limited correlation to, say, the listed equity space as well. Because we think from a whole of fund perspective, that's where the benefit comes from."

Global strategic research director at Mercer Nick White said he agreed with parts of that sentiment but added that unique expertise is needed for engaging with natural capital.

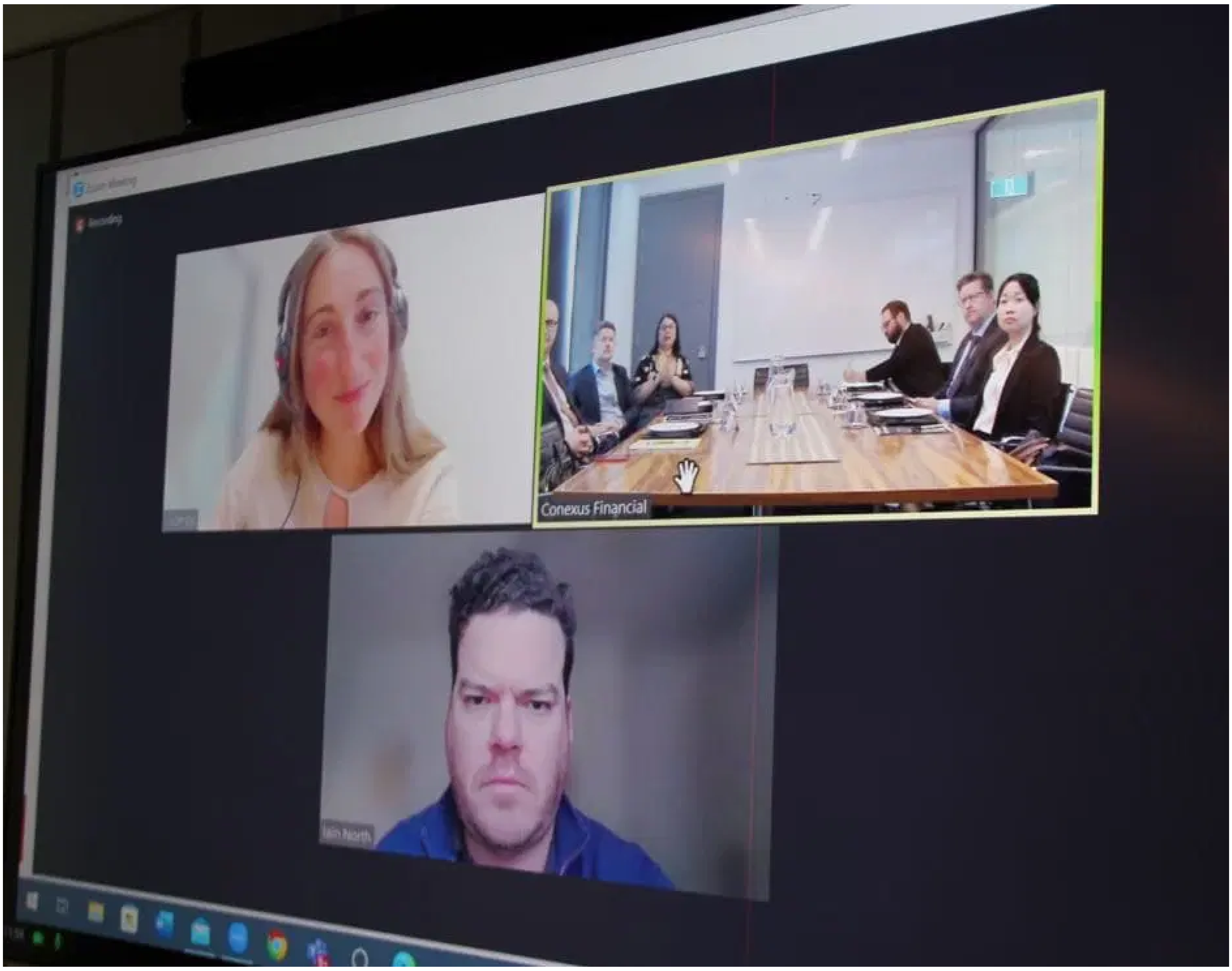
"It shares similarities with other aspects of the real assets market, but it is still different when it comes to being a beneficiary of long-term structural trends.

"It's clearly got different characteristics, both from a positive and from a negative point of view, compared to things like infrastructure and real estate."

GFC hangover

A concern about natural capital that the roundtable heard was investors' historical experience.

"There are just some subjects that you're not allowed to mention again," head of alternatives at investment research company JANA Iain North said of some investors' experience with forestry assets around the time of the global financial crisis (GFC) in 2008-09.



Marina Pasika (top left) and Iain North (bottom)

Confidence in agribusiness (effectively now a sub-sector of the newer and broader term 'natural capital') waned among investors following the collapse of a number of managed investment schemes (MIS). Designed to drive investment in forestry initially, the appeal of investments in MIS products was often based on their tax deductibility rather than their actual profitability. MIS companies financed land purchases with up to 100 per cent debt as it wasn't tax deductible like the actual trees. The scheme later expanded to wider agribusiness (olives, nuts, avocados).

However, the financial tsunami spreading from overseas following the collapse of investment bank Lehman Brothers and major government bailouts of financial firms in the US placed a significant chunk of the local agribusiness MIS sector in administration, as companies suffered from falling share price and demand alongside banks' refusal to financial their debt facilities.

One of the biggest MIS players, Great Southern Plantations, reportedly left 43,000 investors – or "growers", as they were called – out of pocket to the tune of a collective $1.8 billion when it collapsed in 2009.

Rogers recalled that when New Forests launched its first fund 12 years ago, almost all of the investors were European, because the Australian investors "literally just had their fingers burned".

The wood-marble nexus

Now, most of the forestry assets have been reverted to long-term institutional capital, and according to Rogers, the industry has completely been restructured as a result.

"A lot of those trees [planted during MIS] are out of the ground, because they were planted in places that are never going to be economic no matter which way you look at it," he said.

"We've unfortunately deforested at about 100,000 hectares, particularly hardwood, because the trees were planted wherever the finance guys could buy land. They didn't care.

"They planted the eucs [eucalyptus trees] with equity, and they had no vision as to how those trees were actually going to be harvested and brought to market."

Over the years, New Forests bought MIS companies including Great Southern Plantations Land, Gunns (managed by Forico) and more. Some were picked up at discounted prices, giving the asset manager an early advantage, Rogers said. But for forestry to truly make a comeback as an attractive asset class, he said one perception must change.

“People [in Australia] are willing to buy a marble kitchen bench as the same value as the entire stick framing the house. They are very used to subsidised wood.

“That’s the nexus we’re trying to break now. People need to value forests for all the products and benefits they can provide, because there are several competing factors here for land use. We ultimately just need more trees in the ground.”

The long-term lens

Rogers said natural capital has long been an appealing asset class for many Canadian and European pension funds due to its long-term stability.

“For us, it’s part of the joy of what the asset class brings: there’s an underlying stable return in the land,” he said.

L-R: Nick White and Robert Edmond

“We do spend a lot of time talking about what carbon and biodiversity markets are going to look like in 10 or 20 years, but the land, trees and fruits, they’ll be pretty much the same… that’s the core return, all of this other stuff is option value and upside.”

Some investors might find the management of natural capital’s unique environmental risks (pest and bushfire) and political risks (conservation of native forest) challenging. But UniSuper’s Wang said there’s no reason to treat it differently on the risk spectrum, as the fund conducts its due diligence akin to any other private market allocation.

“It [natural capital] has the same risk as commodity market risk, or operational risk like work health and safety.

> “The CIOs have to deliver the return that sets their members over the long-term for their pension, full stop. That’s what they get up for in the morning.” – Mark Rogers, New Forests

“First and foremost, it’s got to make sense from a base return perspective as we say in pretty much every conversation.

“In our Forico investment, they have excellent financial plans, we have a very capable management team who’s been in the assets for a long time… so just because it’s more prone to bushfire, pest or weed doesn’t mean we would view it any differently.”

Natural capital as a sustainability play

Australia's financial sector is going through a significant period of change on the ESG front. While many institutions have come out with a net zero by 2050 pledge, not everyone has a clear pathway or understands the cost and return involved.

JANA's North said natural capital is not yet at the front of mind for many investors as a sustainability play, compared to opportunities in other asset classes.

He conceded that the position from JANA's client base is still about legacy investments. "On the infrastructure side, I think you're still looking at more tech enabled strategies, such as solar, rather than natural capital like water or forestry."

However, Mercer's White – whose remit is global – said that with a small group of Mercer's clients, his experience was that natural capital automatically gets put into the sustainability box, which is welcome to many but not all.

"We have clients all over the globe. While we have some who are very focused on sustainability outcomes, others who almost don't want to talk about the word," he said.

"It's really important as a base discussion to appeal to a broad client base, sustainability is very much the plus that comes in with the demand story and the demographic story. That, in itself, needs to be a strong return story before any of the sustainability aspects."

MERCER, IAIN NORTH, REST, NICK WHITE, NEW FORESTS, NATURAL CAPITAL, MARINA WANG, UNISUPER, MARK ROGERS, ROUNDTABLE, MARINA PASIKA, JANA, ROBERT EDMOND