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NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Sustainable land use: a new field of possibilities

The business model and drivers for natural capital investing have evolved

Investing in natural capital has moved decisively beyond the proof-of-concept stage and is on the way to becoming a mainstream portfolio component.

So much has changed in a short period of time. The drivers for more investment in sustainable land use are becoming clearer and the adoption of the Global Biodiversity² Framework at the United Nations' COP15 for biodiversity in December 2022 has been a decisive gamechanger. There is also greater clarity over the business models employed to leverage these drivers.

In short, investors are recognising that the natural capital story is likely to mirror the trajectory of renewable energy, with, on the one hand, a favorable regulatory environment and, on the other, the development of a real economic sector committed to natural capital restoration.

Gautier Quéru, Managing Director at Mirova, an affiliate of Natixis Investment Managers, says: "This sector is going from strength to strength. From a Mirova standpoint, we now have not only a long and strong track record, but a robust vision of exactly how to invest in natural capital.

"With a solid investment proposition and history moving rapidly in the right direction, it is time for the natural capital sector to scale up."

Market drivers are evolving

It is widely recognised that natural capital suffers from over-exploitation and underinvestment due to activities such as overgrazing, short-term monoculture farming, deforestation and industrialisation.³

More responsible investments and better management of natural capital could solve four key challenges.

The first is demand for wood. Construction materials such as concrete and steel, as well plastic, are being substituted by wood and wood-fibre products to reduce the carbon footprint of the building and other industrial sectors. To allow such a substitution, wood production and processing must be stepped up without creating further deforestation. In fact, forest cover needs to be increased.

The second is food security. The challenge is to do more and better, while using less land with the objective to feed the planet's growing population up to around 10bn people.

The third is climate change mitigation and the reduction of emissions through reforestation and restoration of land.

The fourth is to preserve and restore biodiversity. This became a hot button issue after a Global Biodiversity Framework was adopted at COP15 in Montreal at the end of 2022.



Gautier Quéru
Managing Director,
Natural Capital
Mirova

Key takeaways:

- The ability to deploy considerable funds in sustainable land use projects in emerging markets is now all but indisputable. Strong flows of private capital to natural capital solutions are indicative that this is an investible space with a real impact on the ground¹.
- Capital flows into sustainable land use are likely to increase rapidly as legal and regulatory constraints on international supply chains increase demand for food and materials produced sustainably.
- Mirova's target is to support projects across Latin America, Africa and Asia, fostering agroforestry and regenerative agriculture, restoring land and enhancing local communities conditions, while generating attractive returns for investors.

¹ Source: Preqin, Global Natural Resources Report 2023: as of Q1 2022, 208+bn AUM have been invested in Nature Resources.

² <https://www.cbd.int/article/cop15-cbd-press-release-final-19dec2022>

³ Source: United Nations, 2023: A total of two billion hectares of land are degraded worldwide and through exploitative production, human activities continue to degrade another 12 million hectares of productive land every year.

The key outcome of COP15 was to put in place concrete measures to halt and reverse nature loss, including putting 30% of the planet under protection and 30% of degraded ecosystems under restoration by 2030.

Importers of food and materials across the world now have to increasingly demonstrate that their sourcing is sustainable and not linked to damaging practices such as deforestation or child labour.

Some countries have already enshrined land sustainability in law. And in April 2023, the European Parliament agreed the "Regulation on Deforestation-free products"⁴ requiring companies to undertake due diligence into the sourcing of a wide range of commodities, including cattle, cocoa, coffee, palm oil, rubber, soya and wood.

"We think capital flows into sustainable land use will increase rapidly because the constraints on end-buyers mean demand for sustainable materials will be high," says Gautier Quéru.

How sustainable land use investing works

Investing in sustainable land use means focusing on long-term profit-seeking investments in land restoration projects. These projects can have positive societal effects such as integrating smallholders and local communities.

Mirova provides long-term debt and equity financing for sustainable land use projects and companies in three subsectors (planted forests, agroforestry and regenerative agriculture) that will support the certified production of food and fibre.

Mirova targets positive impacts in terms of climate mitigation and adaptation, biodiversity protection, community inclusion and gender equality.

It invests mainly in developing countries, with an existing pipeline in Africa, Asia, and Latin America, but also intends to undertake projects in developed countries, including Europe, particularly where entrepreneurs propose attractive business models.

A holistic approach can create more value

Mirova's experience of managing natural capital has refined its understanding of the value creation in this sector.

Gautier Quéru says: "There are three types of natural capital strategy in the unlisted markets: (i) classic timberland or farmland, (ii) more innovative carbon finance and, in between, (iii) sustainable land use. We position ourselves firmly in the sustainable land strategy because it provides a balance between value and impact."

A classic timberland and farmland strategy essentially finances land acquisition, with value extracted from productivity increase for crops or timber, resulting in land appreciation. This approach to natural capital can be seen as low-risk, but also sometimes as low-value / impact.

At the opposite of the spectrum, a strategy focused on pure nature protection and regeneration is based on the value of carbon credits (and maybe soon biodiversity certificates) and has no productive activities and no real demand from the real economy. As such, it is high impact but also high risk strategy from a financial perspective, as the performance is strongly correlated to the carbon market volatility.

Between these two sits sustainable land use, which is a more diverse and holistic approach. "We prefer this approach because we can finance the production and processing of food and fibre without necessarily acquiring land," says Gautier Quéru. "It has the multiple benefits of being more agile and having more impact."

Sustainable land use is not just about planting, but also transforming primary production by adding processing units to move value upstream. The processing units can transform the smallholders' production, but also crops from outside the immediate area, adding further resilience to the project. In addition to the plantation and the processing, financing the access to certification, such as organic, fairtrade, Rainforest Alliance, etc. can further increase value.

The desired outcome is the creation of production systems and innovative social enterprises which can enhance and sustain entire communities through selling to local, regional and international markets.

Natural capital investment in action

The potential to deploy considerable funds in sustainable land projects is now indisputable⁵.

"We are finding projects on the ground across Latin America, Africa and Asia where we have restored degraded land and are generating double digit returns⁶," says Gautier Quéru.

Typical projects involve the production and processing of cocoa, coffee, tree nuts, other fruits, wood and also ingredients for the pharmaceutical sector.

Mirova has invested, for example, in Miro Forestry, a forestry company in West Africa. With the financing, Miro Forestry has been able to restore degraded land, expand its planted area and set up new plywood and poles production facilities.

Miro Forestry has planted tens of thousands of hectares of FSC-certified trees across Ghana and Sierra Leone. As a result, the project is expected to sequester approximately 10m tons of CO2 over the next decade and create over 2,000 jobs in Ghana and Sierra Leone.

Another investment is in Kennemer Food in the Philippines. The investment supports Kennemer's implementation of sustainable agroforestry practices as well as the extension of the production capacity in the cocoa and fruit sectors in the Philippines, in partnership with more than 19,000 independent producers.

Kennemer operates by contracting outgrowers who agree to supply the company in return of a guaranteed pricing. Kennemer provides smallholder farmers high-quality planting material, technology and training in good cacao farming practices, post-harvest assistance and facilitation of access to financing.

4 https://environment.ec.europa.eu/topics/forests/deforestation/regulation-deforestation-free-products_en

5 Source: "Shifting finance towards sustainable land use", Climate Focus 2021.

6 Source : Mirova, 2023.

"Our investment allows Kennemer to grow by expanding its small-scale producer programme, implementing initiatives that promote regenerative agriculture practices, expanding micro-finance capabilities, and supporting the development of an ambitious carbon program," says Gautier Quéru.

"Kennemer is also about to get certified as the first carbon credit project in Philippines."

A single project can deliver a number of impacts

An advantage of Mirova's added-value approach to investing in natural capital is that it suits the needs of many types of impact investors.

After taking the decision to make impact investments, investors may focus on a narrow subset. This could be carbon emission reduction, job creation, biodiversity protection, social inclusion and so on.

"What we like about the diversity of our projects is that they often encompass a number of impacts," says Gautier Quéru. "Whether investors come to us for climate mitigation, forestry conservation or societal change, we work hard to develop

a solution that meets their needs and, importantly, offers genuinely high impact."

Most projects involve long-term debt investments, a few offer equity. Equity is only used where there is a clear exit route and a balanced risk profile.

At the portfolio level, targeted returns are double digit, mainly derived from debt instruments, which often include a profit-sharing component or equity kicker, making the strategy similar to mezzanine debt approaches.

Time to scale up

To pave the way for more investments, Mirova has developed a so called 'blended finance' structure according to which public money provides de-risking or 'first loss' capital, to encourage more capital mobilisation from the private sector. The model of a public-private partnership, successful in so many other spheres, clearly works for investing in sustainable land use⁷.

The power of the blended finance is such that fears that this natural capital is a high-risk strategy have receded and the future is likely to feature more private and less public capital.

"We are not quite ready to go fully commercial, but it's not a long way off," notes Gautier Quéru.

Mirova is getting prepared to manage more capital in that sector and is constantly growing the team by adding new resources, including creating a local presence in Asia, Latin America and Africa.

"Blended finance scheme are now well tested, and together with continuous public sector support, more private capital is expected to be raised and natural capital strategies will scale up," says Gautier Quéru. "This is a necessary next step to creating sustainable land use."

As such it is expected to follow a similar path as renewable energy, which also transformed demand in a critical area and now commands discrete representation in many institutional portfolios.

Published in October 2023.

⁷ Source: "Financing Sustainable land use for people and planet", UNEP, 2019

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