

Natural real assets: Opportunities in natural real assets

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Introduction

Dan Cave, Senior Consultant at Frontier Advisors welcomed Kristina Hermanson from Nuveen Natural Capital (NNC) and Melanie Madders from Clean Energy Finance Corporation (CEFC) to discuss natural real assets, which includes agriculture, timber, and water rights. The discussion built on a paper co-authored by Dean Steinberg (Consultant at Frontier Advisors) and focussed on asset owners considering deeper dives into the sector or making initial investments. Cave acknowledged barriers such as liquidity, data availability, and ESG concerns, but highlighted the impressive performance of PSP Investments, which grew its allocation from CA\$1.5 billion to over CA\$15 billion in ten years, with a 9.7% return over that time to 31 March 2024. PSP's portfolio allocates 6% to natural real assets, of which 44% sits geographically within Oceania, nonetheless this allocation is diversified across agricultural subsectors and geographies. Cave noted this is alongside infrastructure, which sits at a separate 13% allocation for PSP. Cave emphasised both the scale of recent transactions and the variety of investment approaches, suggesting that Australian institutional investors could learn from PSP's success.

Nuveen (TIAA)

Hermanson discussed the portfolio benefits sought by investors like PSP, highlighting parallels with her parent company, TIAA. TIAA has invested in farmland and timberland for nearly 40 years, building a diversified portfolio worth \$13.1 billion USD across 11 countries. Hermanson noted both timber and farmland offer inflation hedging and low correlation to other asset classes. Stressing the importance of geographical diversification, in the beginning, NNC built out low-risk model investments like farm leases, then diversified into horticulture and viticulture. She emphasised the importance of optimising assets and community value. On the investment structure, natural real assets provide both capital appreciation through land, as well as annual income return on the crop. Hermanson noted the core investment lies with the biological asset.

CEFC

Madders discussed CEFC's dual mandate focussing on investment returns and carbon sequestration. CEFC's portfolio includes agriculture and timber, with 4.8 million hectares under management. In targeting net zero goals, CEFC have identified nature-based solutions as a requirement and have integrated strategies such as tree planting, ecosystem restoration and soil carbon sequestration. Madders also noted their investments in natural capital are among the best-performing assets, highlighting the importance of strategy diversification and highest and best land use. On timber, Madders discussed different characteristics of plantation forestry versus environmental planting, with the latter being predominantly focussed on carbon outcomes, the former on log value with a carbon upside. She believes increasing data availability allows for better risk return analysis for these assets.

Regenerative agriculture

On regenerative agriculture, Hermanson discussed NNC's impact on reducing risk, enhancing returns, and overall impact. Nuveen has a long-standing focus on regenerative practises, which Hermanson noted the best farmers have always been practicing with things like crop and soil rotation. She

explains these practices are not really anything new and NNC are now much more deliberate about these practises under their nature-based solutions strategy. NNC collaborated with The Nature Conservancy to develop a nature-positive farming framework, focussing on land and soil management, water, climate adaptation, resilience, biodiversity, and community. Some specific practices include crop rotations, technology trials, and environmental plantings to improve soil health and biodiversity.

Hermanson said real outcomes can include savings on herbicide sprays of up to 80%, and potentially 20-30% increase in yield by maintaining soil and water retention. Madders added that valuations have materially changed over the past ten years, shifting from commodity metrics such as carrying capacity and comparable sales, to things like carbon metrics or grass valuation for livestock.

Carbon credits

When looking at carbon credits or ACCU's, Cave highlighted their meaningful boost to returns, but also the difficulty in underwriting these schemes on a global basis. Madders added credibility to the Federal Government regulated market, which she noted underpins its methods in science. Further, she noted both clear guidelines and a modelled sequestration rate both exist, allowing for comfort with the data available. Forecasting can be done with ACCU spot prices and Madders noted the emergence of offtakes, with more companies buying offsets and signing up to longer term offtakes. All providing more certainty and enabling investment. Madders mentioned the trade-off with agricultural production when looking at environmental plantings and the importance of considering highest and best use for the land. A key takeaway with timber harvesting is the importance of aligning timeframes of investor preference and harvesting rotations.

Water

Cave introduced the topic of water rights and asked Hermanson to share her perspective, focussing on irrigated versus non-irrigated agriculture from a user's viewpoint. Hermanson explained NNC's portfolio includes significant investments in water rights with a 25% allocation within Australia. She noted Australia has a well-regulated market for water rights which places it ahead of many other jurisdictions, furthermore, water has topped even land in Australia over the last five years despite lands strong appreciation. Hermanson stated the most important aspect for water management is, regardless of strategy, efficiency. In practice this requires the best technology for monitoring, automatic irrigation, scanning and sampling.

Measurement

Turning the topic to measurement, Cave asked Madders to provide some insight on where to start. Madders explained their organisation identified a lack of consistent metrics for sustainability outcomes across various natural capital investment strategies. To address this, they developed a publicly available report called 'Measuring What Matters', which outlines priority activities and feasible, cost-effective metrics for decarbonisation and sustainability. CEFC developed these metrics to measure actual outcomes, with a focus on practicality and certainty gained. They aim to build a consistent data set by asking managers to report on these metrics. Madders also highlights the role of emerging technologies like LiDAR in improving measurement and reporting and their investment in early-stage companies developing these technologies.

Livestock

Regarding livestock, Cave noted the heightened sensitivities and risks involved. Hermanson explained NNC has a long history with livestock, particularly in mixed farming, but has focussed more on land rich sectors due to the complexities and risks of livestock. She highlighted the importance of genetics and best practices for methane reduction and efficient grazing. Madders added that while some investors avoid livestock, especially in Europe, CEFC have livestock investments seeking to drive decarbonisation and improve practices. She discussed the use of methane inhibitors, pasture rejuvenation, and herd management. Madders also mentioned a discounted debt product developed with CSIRO to support emission-reducing activities on farms. Cave asked about next steps for the dairy industry, with methane posing an issue with emissions. Madders said while opportunities in the space are energy intensive, there are companies gaining scale benefits, but more remains to be seen.

Conclusion

The discussion covered various aspects of natural real assets, emphasising the importance of geographical diversification, optimising assets and community value. Key takeaways include the impressive performance of PSP Investments; the benefits of regenerative agriculture practices; the role of carbon credits in boosting returns; and the need for efficient water management. The conversation also highlighted the importance of consistent metrics for sustainability outcomes and the complexities of livestock investment. Cave acknowledged the challenges for natural real assets in both portfolio inclusion and ESG discussions.

Next steps

If you would like to understand more about investment opportunities in natural real assets or are keen to discuss your observations, please contact Senior Consultant, Dan Cave at dcave@frontieradvisors.com.au, who can assist with modelling or manager research.