

INVESTING IN NATURAL CAPITAL – BENEFITS AND BARRIERS

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WHAT IS NATURAL CAPITAL?

Investors cannot afford to ignore natural capital – the elements of nature that directly or indirectly produce value to people – in their investments. The financial risks and non-financial risks, e.g. climate change, biodiversity loss, are too great.

There are three main ways that you can take account of natural capital in your investments:

1. Make a specific allocation to projects that establish, preserve, protect, and enhance it.
2. Incorporate an investment's impact on natural capital when assessing its risks and the sustainability of its growth rate. Use this information when allocating assets.
3. Engage with companies you are invested in, to increase awareness of how they affect, and rely on, natural capital. Encourage them to incorporate this in their decision making and shift towards approaches which are more sustainable with respect to natural capital.

Natural capital covers all living things (biodiversity), as well as things which exist in finite supply, such as soil and minerals. The value of natural capital includes ecosystem services, such as clean air and water, food, biodiversity, flood defences, and recreation.

It is vital for economic activity – an estimated \$44 trillion of economic value depends on natural resources, equivalent to more than 50% of global GDP, according to the World Economic Forum.

But natural capital should not just be viewed through an economic lens. It also covers the fight against climate change. Many elements of natural capital – such as forestry, peat bogs, mangroves, kelp, salt marshes, and soil – absorb carbon from the atmosphere in a process known as carbon sequestration.

It has been estimated that efforts focused on natural capital could contribute about 30% of the climate mitigation needed to deliver on the Paris Agreement 1.5°C target.

Natural capital also covers biodiversity – the variety of life on Earth. And we have been very poor custodians of this. The biodiversity loss which occurred since 1970 is on a par with previous mass extinctions, of which there have been only five in the past 450 million years. Biodiversity loss also undermines progress towards many of the United Nations' Sustainable Development Goals.

HOW DOES IT RELATE TO INVESTMENT?

As natural capital underpins so much economic activity its degradation puts that economic activity at risk. And investment in it can have financial, as well as non-financial benefits. For example, dirty/polluted water has health consequences for the communities that are forced to drink it and financial consequences for any public or private sector body that has to purify it (as well as any direct and indirect financial costs which result from people's ill health).

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BARRIER 1: LACK OF REVENUES

In order to attract most institutional investors, such as pension funds and insurance companies, an investment has to generate an acceptable expected financial return. Projects which offer no financial return, and are done for positive impact alone, are philanthropic, or charitable, work.

The issue is that many of the benefits that goods and services derive from nature go unpriced. Who pays for the benefits of a cleaner river? Or a more diverse natural ecosystem? Failure to recognise and price these benefits makes it challenging to derive revenues from them, which makes it hard to generate a return stream for investors.

That is a major reason why private sector finance has made up [only around 14-20% of global conservation finance](#), and only a portion of that comes from return-seeking investors. The public sector has been responsible for the overwhelming majority.



For the purpose of this paper, the first of these covers stand-alone investments that an institutional investor could make in natural capital projects. This is the focus of this paper.

The relationship with existing portfolio investments, such as public equities or bonds, is covered in the second and third points. This is also covered in greater detail in an upcoming paper.

Investing in natural capital projects may seem the most obvious but, other than in some very specific areas – carbon offsets (described on next page), for example – it can also be the hardest in practice. Three barriers stand in the way. Better measurement of natural capital is the linchpin which can help to overcome all three. Thankfully, this is also where there is great cause for optimism.





The main exceptions to the lack of revenues problem are investments which yield carbon offsets (often in conjunction with other revenue streams, such as improvements in agricultural efficiency). These are credits which reflect the amount of CO₂ a project removes from the atmosphere (see boxed section for more details). These credits (which can be tradable) are in demand from a variety of parties, to help them meet their commitments to reduce their CO₂ emissions to net zero ("net" because it is generally not possible to eliminate emissions entirely, at least for the time being). Offsets can be sold to these third parties to generate a revenue stream.

Alternatively, those same parties can invest directly in natural capital projects which yield offsets, avoiding the need for them to buy them elsewhere, and providing

greater certainty on the quality and provenance of those offsets (see the data section later for more on this) as well as the broader co-benefits to people and planet.

That is not to say that other natural capital projects do not have financial benefits. They clearly do, given that more than 50% of global GDP relies on nature.

It's just that the many of the payoffs from specific investments made to improve natural capital come about indirectly e.g. through avoided costs, rather than by throwing off cold hard cash. And there are often many beneficiaries rather than just one. This can make it hard to agree on who should pay, and risks a free-rider problem, where one pays and many benefit.

CARBON OFFSETS

Carbon offsets, or carbon credits as they are sometimes called, are instruments which reflect an emissions reduction of one metric tonne of CO₂.

This reduction can come about either through emissions-mitigation (still polluting but lower than it would have been), emissions-avoidance (stop an activity that would have released emissions), or the removal of CO₂ from the atmosphere (such as planting trees which sequester carbon naturally as well as technological solutions that suck carbon from the atmosphere and store it beneath the ground).

For example, a company which releases CO₂ as part of its operations could reduce its net impact on the environment by purchasing and 'retiring' any one of the three types of offsets mentioned above.

Retirement occurs when a holder removes offsets from circulation and 'banks' the emissions reduction for themselves. Before then, many offsets can be traded between parties (although some issuers place restrictions on this). It is only once an offset has been retired that a holder can put it to use against a net zero or other emissions reduction goal. After this it can no longer be sold.

Although the only realistic way for most companies to achieve carbon-neutrality today, offsets are a controversial

topic. And many grievances are justified. For example, if they take priority over attempts to reduce emissions, they allow polluters to keep polluting.

Another concern is over the quality of offsets. There have been cases where offsets have been overstated or have [resulted in significant harm to local communities](#) e.g. removal of land that was used for growing food and grazing livestock, and human rights abuses in project construction, to name but two.

It doesn't have to be this way. Carbon offset projects can be done in a way that is sensitive to natural capital, while also creating jobs among local communities. For example, paper companies in Brazil have taught local farmers how to plant trees so biodiversity is not lost, and how to manage tree-cutting in a sustainable manner.

The price of offsets varies between as little as a few cents to as high as several hundred dollars, one very transparent way to see that all are not alike.

We believe that offsets 'rank' below reduced emissions, so should only be used where opportunities for demonstrable reductions in emissions have been exhausted. These are the residual emissions that can be offset while new technologies and new methods of emissions reduction are developed. Care should also be taken when buying them, to ensure quality e.g. by buying on regulated exchanges, or where certification from recognised authorities have been given.

Figure 1: Example financial benefits of natural capital

Supply chain quality/ reliability	Lower insurance risk e.g. flood/health
Improved crop yields	Lower healthcare costs
House price premium for proximity to parkland	Lower remedial costs e.g. water treatment, flood damage repairs
Tourism	

Source: Schroders.

In the earlier water example, the financial beneficiaries from cleaner water include, but are not limited to: the health service, health insurance companies, water utilities, farmers, the fishing industry, and companies which rely on water as an input to production. Some of these benefit by lowering their costs e.g. healthcare

costs, water treatment costs, others by higher or more sustainable returns e.g. better crop yields or healthier fish populations. Benefits can also be realised over very long timeframes. Who should pay to ensure cleaner water? All of them? In what proportion?

BARRIER 2: SMALL SCALE PROJECTS MAKE IT HARD TO ALLOCATE LARGE AMOUNTS OF MONEY

A further barrier to attracting greater institutional investment in natural capital is that many stand-alone projects are small in scale. For example, the average UK forestry transaction in 2020 was for £3 million and UK-wide recorded sales are estimated to have been [about £200 million](#) in total. The combined value of all recorded UK forestry sales over the last decade has been just over £1 billion.

Globally, [a survey by the Coalition for Private Investment in Conservation \(CPIC\)](#) found that 70% of all deals that respondents participated in during 2020 were for less than \$1 million, with 85% less than \$5 million. While this survey of 35 respondents and 237 deals covers only a sample, it is consistent with findings elsewhere about small transaction sizes.

These figures are too small for a large institution, managing several billion pounds of assets, to allocate to, let alone the institutional investing community in aggregate. Larger markets exist in some areas, but this example highlights the challenges that many individual markets can have in attracting institutional capital.

The overlap of natural capital and scale comes more readily via companies that investors have exposure to elsewhere in their portfolios, than in stand-alone natural capital projects e.g. better supply chain management by a listed company. This is where engagement can make a difference, as described later.

BARRIER 3: DATA SHORTCOMINGS HAVE STOOD IN THE WAY OF SCALING UP

There can also be a lot of variety between projects, a barrier to consolidating them to achieve economies of scale. A lack of standardised data also stands in the way of aggregating investments and measuring impact.

Even within a single country, there are overlaps and inconsistencies. This also makes it hard for large investors to allocate large sums of money – they have to allocate a lot of resources to understanding each individual project. 70% of respondents to [the CPIC conservation finance survey](#) complained that the high costs of quantifying impact was a barrier and nearly half said a lack of standardised measurement metrics

was an additional challenge. To build up a portfolio of sufficient size to make a difference to their returns quickly becomes impractical for most institutional investors.

As well as being an issue for stand-alone investments in natural capital, data shortcomings are also a barrier when it comes to assessing companies in public markets. Limited traceability makes it difficult for companies to assess and manage their supply chains, which makes it difficult for investors to understand their exposure.

BETTER DATA NEEDED TO OVERCOME ALL THREE

High quality, reliable, robust, and consistent data on natural capital is necessary to overcoming all three of these barriers. It can enable:

- projects to be analysed by investors in a more standardised manner, reducing due diligence costs
- small projects to be pooled together with similar projects to a scale that can attract institutional interest

- opportunities to enhance natural capital value to be assessed, and the subsequent measurement of any impact measured
- data on projects to be measured, aggregated, and reported at a portfolio level
- objective, data-driven, discussions to take place between the multiple parties who benefit from natural capital, key to any discussion about how costs should be shared (which could drive a revenue flow)

Thankfully, this is one area where there is genuine reason to feel optimistic.

Companies such as [Natural Capital Research](#) have developed academically rigorous models to measure and provide insights on natural capital. These make it possible to measure the baseline value of natural capital assets, advise on ways to enhance their value, and then report progress relative to that baseline.

And the Align project, Aligning Accounting Approaches for Nature, which was set up by the European Commission in March 2021, aims to develop standardised natural capital accounting practices for businesses, including a standardised approach to biodiversity measurement.

In public markets, many of the reporting frameworks that have been established to tackle climate change are now being developed for nature. For example, the Task

Force for Nature-related Financial Disclosures (TNFD) is set to launch its framework in 2023. This will be modelled on the Task Force for Climate-related Financial Disclosures (TCFD), which sets out best practice in climate reporting and is fast becoming mandatory across numerous geographies. The Science Based Targets Network are also developing Science Based Targets for Nature (SBTN), which will provide guidance to corporates on assessing nature-related risks and setting effective targets.

While these frameworks may take a few years to formally arrive, pressure is already growing on companies and investors to assess, manage and disclose nature-related risks.

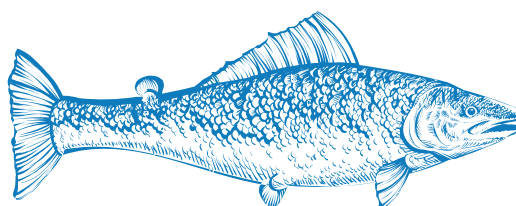


Figure 2: Measuring natural capital

Atmospheric carbon stored	Tonnes CO2e/ha
Atmospheric carbon sequestered	Tonnes CO2e/ha/yr
Soil erosion prevention	Tonnes avoided soil loss/ha/yr
Flood risk reduction	M3 surface runoff avoided/ha/yr
Clean water	Tonnes nutrient runoff ha/yr
Land for recreation	Important areas – visitors/ha/yr
Pollination	Important areas – ha
Biodiversity	Important areas – ha; index of connectivity

Source: Natural Capital Research.

AND DATA CAN ENHANCE CARBON OFFSET INVESTMENTS

Better data can also overcome some of the justifiable concerns about the low quality of carbon offsets that exist.

It enables a more objective assessment of the characteristics of what you are buying. It can also make sure that any investments in offsets are not to the detriment of natural capital, something all sustainable investors should care about.

INNOVATIVE THINKING IS NEEDED

As well as better data, innovation in how natural capital projects are financed has the potential to unlock pools of capital. Carbon offsets are one such example and, if done correctly, can play an important role in both conserving and improving natural capital, and helping efforts to reach net zero. But more creativity is required to think about areas which generate value outside of carbon sequestration.

Figure 3 sets out four promising areas: resilience bonds, cost-sharing agreements (of which the Forest Resilience Bond is a good example but, confusingly, has a different meaning to the more general use of the phrase “resilience bond”), green bonds, and blended finance.

The first two, in particular, are ways to explicitly capitalise the financial benefits of improving the state of natural capital, and connect that to payments made to investors. The third recognises that the Green Bond Principles list natural capital as a permitted use of funds, but this area has attracted limited interest so far. It, potentially, is the lowest hanging fruit given the huge appetite investors have for these bonds. And the fourth is a way for the public and private finance to work in tandem to build a pipeline of investment-ready projects.

One further development that could have a transformational impact is the emergence of investment funds focused on natural capital. By pooling investors' assets, they can allow even small-scale retail investors to invest in natural capital in a risk-managed, diversified, way.



For example, planting trees for carbon offsets can greatly reduce biodiversity, acidify and erode soil, harm hydrology, increase fire risk and introduce invasive species to an area. A considered approach to tree planting, taking account of native ecosystems, can mitigate or overcome these. This is something that good data on local biodiversity, soil, climate etc, as well as the carbon sequestration potential of different planting schemes, can enable.

Figure 3: Innovation in natural capital financing

Resilience bonds

Resilience bonds are like a form of catastrophe bond, with a resilience overlay.

At a very high level, in a standard catastrophe bond investors put money up and in return they receive income from insurance premiums that have been paid for protection against the risk of things like hurricanes, storms, and earthquakes. Their initial investment is kept safe to cover any payouts needed if a natural catastrophe of specified severity occurs. If one doesn't, this money is returned to them at the end of the contract.

Premiums are set at a level to more than cover expected insurance payouts over time, and provide an expected financial return to investors.

If money was to be invested in a way which reduced catastrophe risk, then expected losses and premiums would both fall. For example, mangrove reforestation can reduce the risk of flood and storm damage. This is the essence of a resilience bond. Those premium “rebates” are capitalised up front and used to pay for the resilience project. This results in a lower yield for investors (due to lower premium income) but also lower expected losses.

Resilience bonds have the potential to deliver attractive risk-adjusted returns to investors, while also channelling institutional capital towards particular types of natural capital project (those which provide protection against natural catastrophes).



COST-SHARING AND STANDARDISING: US FOREST RESILIENCE BOND (FRB)

Capital is raised from investors to pay for forest restoration. Repayments can be fixed or vary depending on the success of the project, over time horizons of up to 10 years.

The cost of making those repayments is shared between the stakeholders who benefit from a project's outcomes, such as reduced fire risk and improved water quality, e.g. federal and state land management agencies, water and electric utilities, water-dependent companies, and private landowners.

Smaller planned projects will be standardised where possible to enable aggregation, streamlining due diligence and attracting larger pools of capital.

A successful initial \$4 million pilot scheme in the Tahoe National Forest cut the timeframe for a restoration project [from a projected 10-12 years to only four years](#). Off the back of this success, a partnership has been established to finance more than \$100 million of restoration work in North California with an FRB.

The FRB is evidence that cost-sharing and collaboration can work. Important considerations are getting agreement on the framework for how benefits are measured and apportioned and the choice of partners.

GREEN BONDS AND SUSTAINABILITY-LINKED BONDS

Green bonds are ways for companies (and countries) to raise money for [environmental objectives](#) such as: climate change mitigation, climate change adaptation, natural resource conservation, biodiversity, conservation, and pollution prevention and control.

With a sustainability-linked bond, the difference is that the interest rate on the bond depends explicitly on performance against one or more sustainability performance targets.

The green bond market is growing rapidly and attracting increased interest from investors. Issuance has grown [from only \\$50 million in 2014](#) to a forecast of [\\$500 billion for 2021](#). More than \$1 trillion is forecast for 2023. The sustainability linked bond market is smaller but also growing rapidly.

Much issuance in this area has focused on renewable energy and energy efficiency. Only about [5-10% of green bond issuance](#) has been for nature-based solutions, or the conservation or enhancement of biodiversity.

But there is no reason why they could not play a more prominent role in channelling money towards natural capital. Companies which rely on natural capital for their supply chains have a clear financial incentive to do so.

The UN estimates that investments in sustainable supply chains hit \$7 billion in 2020. Companies such as Unilever,

Apple, Amazon, Procter & Gamble, L'Oreal, Chanel, and Kering have all raised nature-focused funds in the past two years. They often do this by partnering with non-governmental organisations (NGOs) such as Conservation International, the World Wildlife Foundation (WWF) and the Nature Conservancy. There is also usually a link with corporate commitments to net zero carbon emissions and/or biodiversity or nature-positive goals.

Another good example is the Brazilian paper company, Klabin. It recently issued a sustainability-linked bond where the coupon is linked to its [water consumption intensity, water reuse and also to biodiversity preservation](#) (to reintroduce or reinforce at least two extinct or threatened species against the initiation year of 2019).

There is no reason why more companies should not be taking advantage of investor demand, by issuing green or sustainability-linked bonds to finance investments in nature-positive outcomes and sustainable supply chains.

The same applies to national and local governments, which face costs which are sensitive to natural capital. For example, Germany (forest protection), Italy (marine life protection), and the UK (biodiversity conservation) have all issued green bonds where part of the proceeds are earmarked to protect and conserve nature.

Many governments have set themselves targets around conserving and improving their natural capital. Greater use of green bonds would be an obvious way to finance these ambitions.

BLENDED FINANCE

Blended finance is the use of development finance (provided by governments and/or development banks) alongside private finance.

Development finance is often used to get a project 'investment-ready'. This can mean grants to cover project design, proof of concept, and technical assistance. It can also mean guarantees, risk insurance, and concessional (below market rate) financing. This involvement de-risks the project, making it more appealing to private investors.

For example, the [Nature+ Accelerator Fund](#) (the Accelerator) "aims to leverage an \$8 million anchor investment from the GEF [Global Environment Facility] to develop a portfolio of \$200 million in transformative, scalable and financially viable nature-based solution projects". It backs and supports projects from seed stage (convertible notes and repayable grants of less than \$100,000) through to venture phase, where larger sums can be invested. They aim to attract up to \$160 million of co-investment beyond the Accelerator money to scale projects up further.

Without the small-scale investments and early stage support, the pipeline of larger raises would never be possible. But without the commitments of larger sums, the early stage financing may also go nowhere. Blended finance is a way to get natural capital projects to the stage and size where institutional interest is likely to pick up.

Source: Schroders.

NATURAL CAPITAL RISK AS AN INPUT TO PORTFOLIO CONSTRUCTION



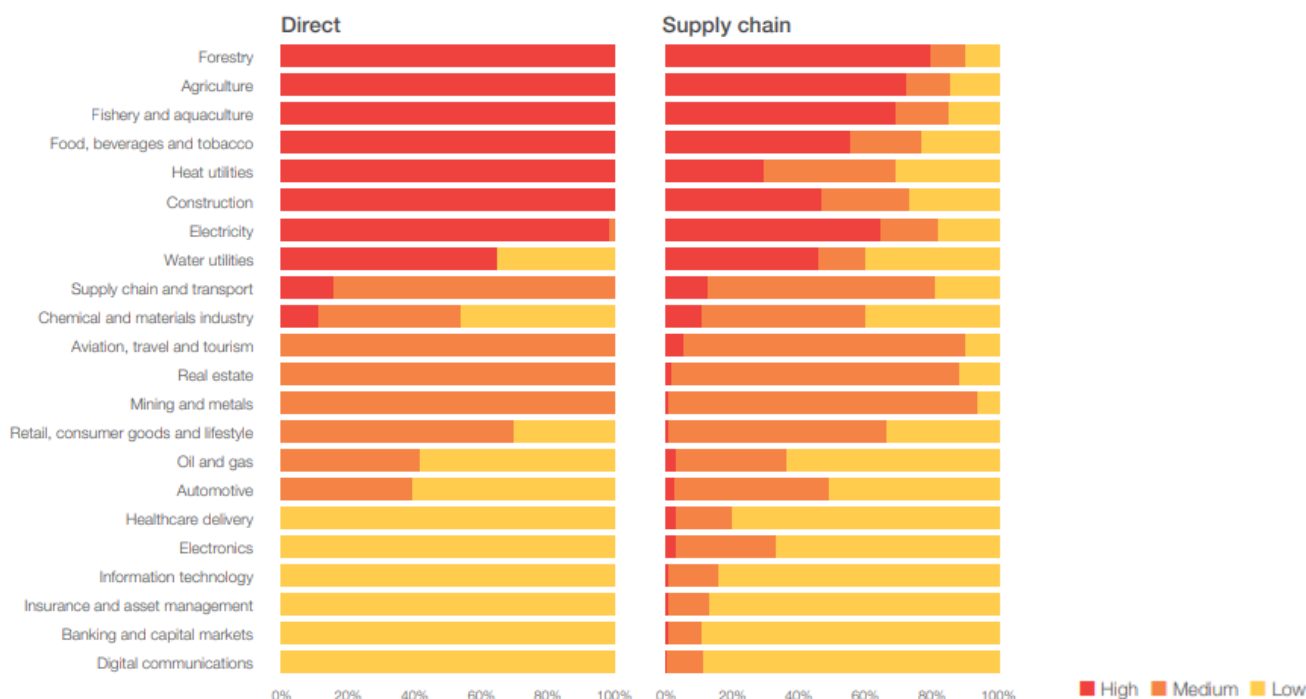
An economy or company which generates growth by depleting or degrading its natural capital is likely to face long-term headwinds and put its growth at risk.

An obvious example would be over-farming or over-fishing. While that could boost output in the short run, it would hurt it in the long run by ruining soil quality and depleting fish populations. Thinking more generally, there are a number of risks for companies. These include disruptions to operations and supply chains, regulatory risk, reputational risks, and financial risks (e.g. through higher insurance premiums and/or financing costs).

The aggregate impacts of these can be negative at an economy-wide level e.g. reduced productivity, price shifts, capital destruction, and labour market frictions.

The table below highlights sectors that have high levels of dependence on nature, either through their direct operations or through the value chain: nature-related risks are deeply interlinked with investment portfolios.

Figure 4: Percentage of direct and supply chain Gross Value Add (GVA) with nature dependency



Source: [WEF](#), [PwC](#).

As well as dependency on nature, another important consideration when analysing investments is impact on nature. A business that harms natural capital to generate its growth is likely to find the sustainability of that growth impaired. Businesses that are better custodians will be better positioned to thrive. By analysing investments through this dependency-impact lens, investors can obtain a deeper and fuller understanding of their risks and prospects. This can enable better decision making.

More detail on the natural capital risks to the corporate sector will be covered in an upcoming paper.

For more on the need to look beyond GDP when assessing economic growth, please see:

[Beyond GDP-why natural capital matters](#)



ENGAGING ON NATURAL CAPITAL

While investing in pure-play natural capital projects has its challenges, one area that institutional investors can take immediate positive action is in using their voice. We have seen this happen increasingly on climate change in recent years. Nature is the next frontier.

As already pointed out, many companies (and economies) are dependent on natural capital. But, because it and the ecosystem services it generates often go under-priced, this can lead to excessive or reckless use of natural capital.

By engaging with companies on the environmental and social costs to nature of their activities, and the financial risks this ultimately entails for them, investors can drive adoption of more sustainable practices (see deforestation case study on next page). For companies, investors, and nature, this would be a win-win-win.



ENGAGEMENT CASE STUDY: DEFORESTATION

Key drivers of deforestation have been the clearing of forest land to provide pasture for cattle, croplands for soy and palm oil, and tree plantations for timber. Complexity of supply chains makes it difficult to accurately assess corporate exposure to deforestation, especially as many of those involved are small farmers or producers. A more effective approach is to engage with larger companies further down the supply chain.

Sector	Industries	Exposure
Consumer staples	Household & personal products Food products; food & staples retailing	Exposure to all food commodities and paper products for packaging
Consumer discretionary	Autos suppliers Consumer durables Textiles, apparel and luxury goods Hotels, restaurants & leisure	Exposure to leather and rubber, wood pulp and timber, as well as food commodities for restaurants
Materials	Containers and packaging; paper and forest products	Exposure to timber and paper

Source: Schroders.

Analysis of a company's commitments and actions to end deforestation, and conversations with their management, can then allow us to build up picture of who the good and bad apples are.

For example, do a company's commitments to end deforestation extend across its supply chain? Do they even have good traceability of their supply chain? Does it impact management remuneration? How transparent is the company with investors?

This analysis and engagement allows us to gain an insight into companies that are managing this risk adeptly compared with those whose practices are lagging, and where engagement is most needed.

CONCLUSION

There are three main ways that you can take account of natural capital in your investments:

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Improving data quality and availability is making it easier to do the second and third today. And this is only going to get better. Investors cannot afford to ignore natural capital risks in their investments. The financial and non-financial risks are too great.

The first is more challenging. Projects which yield carbon offsets have attracted most interest and are likely to continue to do so, given the collective drive towards net zero emissions. But that should not be at the expense of projects spanning other areas. Although there are barriers, innovative, collaborative, financing structures show that these are not insurmountable. Creative thinking, and collaboration between all stakeholders, will be needed if we are to find solutions to these pressing problems.

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