Birds and Bees and the ESG

Featuring:

Gillian Mollod, *ESG Researcher, MSCI*

Yu Ishihara, *ESG Researcher, MSCI*

Bentley Kaplan:
Hello, and welcome to the weekly edition of ESG Now. The show where we look at how the environment, our society and corporate governance affect and are affected by our economy. I'm Bentley Kaplan, your host for this episode.

On today's show, we're going to start off with biodiversity. The irresistible momentum of the task force on nature related financial disclosures is prompting more questions than answers. And for national governments, another delay in COP15, a key international biodiversity summit is maybe time that the world can ill afford to lose. While investors feel increasing pressure to act, we'll take you through some data sets that show the shape of the challenge ahead. And then, we're going to revisit the wild world of EVs spec mergers to take you through a post mortem of an electric vehicle startup that filed for bankruptcy less than a year after listing. Thanks for sticking around. Let's do this.

In a previous life, long before I was co-hosting this podcast and writing about ESG and the financial sector, I was dead set on working in conservation, and doing whatever I could to protect biodiversity and strengthen underlying ecosystem services. So, for me, personally, it's encouraging to see growing efforts in the financial sector to better incorporate biodiversity risks and externalities in investment decisions.

And right, there are two ways to think about biodiversity if you're an investor. The first isn't how company activities or products or supply chains impact on biodiversity. Specifically, result in the loss of biodiversity. From ready examples, like the plastic six pack rings that are washed into the ocean and end up choking sea birds and turtles to the much more extensive impacts that result from large scale agriculture. Indeed, it's estimated that more than a third of the world's land surface and nearly 75% of freshwater resources are now devoted to crop or livestock production.

What's really changed though in the past few years is the understanding that biodiversity loss has implicit financial and human consequences. The World Economic Forum estimates that half of the world's GDP is moderately or highly dependent on nature. And acknowledging our economic dependence on biodiversity and acting on it is an increasingly time sensitive imperative.

To quote from a UN report from May this year, land degradation has reduced the productivity of 23% of the global land surface. Up to $577 billion in annual global crops are at risk from pollinator loss and 100 to 300 million people are at increased risk of floods and hurricanes because of loss of coastal habitats and protection. So the need is dire, but despite the alarm bells ringing clearly and loudly, governments and the global investor community have been a little bit slower in responding to challenges of biodiversity compared to those of climate.

On paper, let's take two examples starting with international cooperation of the Conference of the Parties or COPs are the decision-making bodies responsible for monitoring and reviewing the implementation of UN conventions. The COP on climate has met 26 times since 1995. The most recent being in Glasgow in October last year. By contrast, the COP on biodiversity is only onto meeting number 15 since 1994, which itself has been delayed by two years currently scheduled to be held in Montreal at the end of the year.

And then there are investor of financial frameworks. The Task Force on Climate-Related Financial Disclosures has only been around since 2015. But it's reporting format, the so-called TCFD report is fast becoming a standardized way for companies to report on their climate risks and impacts. It's biodiversity counterpart, the Taskforce on Nature-Related Financial Disclosures only launched in 2021. And the first beta version of the TNFD report only came out in March this year. So why are biodiversity efforts trailing those in the sphere of climate change? To look at one angle for answering this, I talked to Gillian Mollod out of our New York office. And for her, the data is key.

Gillian Mollod:
I think one thing to note about biodiversity is it's a multifaceted and complex topic. You're looking at a lot of different factors that are going to impact biodiversity in a negative way or you can't just look at water, you have to look at water and air and land and changes over time. And one thing that people come to us and ask for is the CO2 equivalent metric for biodiversity loss. And there really isn't one yet.

Bentley Kaplan:
Right. Data for climate related investing has an inherited advantage over biodiversity. There's a simple quantifiable metric that can at least start you off. From basic greenhouse gas emissions, you can open up to more complex questions like scopes one, two, and three. And critically, a ton of emitted carbon dioxide in the US is at least partly comparable to a ton of carbon dioxide in Norway or China or Malaysia.

But biodiversity doesn't have that basic starting point. As Gillian points out, quantifying biodiversity in the first place is complex and difficult. And so variable depending on where in the world you happen to be. And once you've quantified biodiversity, then you have to figure out how specific business activities impact that biodiversity. And then, the financial implications of that biodiversity loss, which sits at the very end of a long chain of events. And right now scientists are busy laying the groundwork.

Gillian Mollod:
So historically, biodiversity data sets have emerged slowly, and they don't often get updated and this is usually because they're created by academic institutions who don't often have the funds to continually update and maintain these large global data sets. But we're starting to see this change a little bit, and we're also starting to see organizations get involved. So, for instance, we have the University of Maryland developed a tree cover loss data set that they distribute through the World Resources Institute. And then, I looked at this mean species abundance data set, and that was developed by a group of scientists in the Netherlands.

Bentley Kaplan:
And these inroads into more accessible and actionable data is giving investors more to work with. Gillian, along with Arne Klug, out of MSCI’s Frankfurt office, put some of this early data to work.

Specifically data from the global biodiversity model or policy support or GLOBIO. Using something called mean species abundance. And in oversimplified terms, that's an estimate of how intact local biodiversity is based on the extent of six human pressures. Things like land use, road disturbance and habitat fragmentation.

And using this mean species abundance data, Arne and Gillian could look at whether any specific industries may have more potential for affecting biodiversity. A note to the hopeful listener is that for all of the data we're about to describe, we're not yet at the stage where we can map the financial consequences of biodiversity loss back onto individual companies or industries. It's a key piece at the puzzle and maybe one that will be able to cover on future episodes. For now, we're talking strictly about company or industry impacts on biodiversity. Their so-called externalities.

Gillian Mollod:
We looked at those industries that are analyzed under our key issue, biodiversity and land use. And we use our biodiversity land as a measurement. I meant management score to assess which companies are managing their biodiversity related risks and which companies maybe aren't doing such a good job at managing it. And we compared this to the number of operations in areas that were what we considered sensitive biodiversity.

And so, we identified all companies with operations in these areas and compared that to the number of operations we have in our asset location database. Metals, and mining, and construction materials were the two industries that had the below-average biodiversity and land use management scores, alongside a higher percentage of operations that we deemed to be in biodiversity-sensitive areas.

Bentley Kaplan:
As Gillian explains, the author started with the globe bio data. Picture a grid covering the whole world with each teeny tiny square having its own measure of mean species abundance. In using MSCI's asset location database, they found that two industries stood out. Mines and construction materials, which are largely focused on cement. These industries had more of their assets in sensitive areas than other industries. But then the authors cross-referenced this location data with data from our ESG ratings model. Specifically, on whether companies had things like deforestation policies or measurable targets to lower biodiversity impacts or programs to boost sustainable certifications in their supply chains.

Not only did mining and cement companies have assets in sensitive areas, but they also looked relatively unprepared to limit their impacts on biodiversity. And these types of results are a starting point. They offer an interesting opportunity for investors that are looking to either integrate biodiversity considerations into their processes, or looking to engage with specific companies. As with any early analysis where data are new and growing, Gillian had some caveats.

Gillian Mollod:
One thing I just wanted to point out is that for instance, food products and marine had low management scores, and also, a low percentage of locations in these quote unquote, "biodiversity sensitive areas." And part of this is just a gap in locations. So we don't have supply chain data on food products. And I think supply chain for food products were really where you're going to see the most impact is along the supply chain.

And then, this is a measurement of terrestrial biodiversity so I don't think it really captures everything that's associated with the blue economy or marine. In the meantime, I think what we are starting to see is that we're seeing a lot of these large global data sets made available, and they contain things like biodiversity-sensitive areas, and healthy forests, and areas that are important for protection, and areas that have a lot of carbon sequestration potential.

So, really, taking all these data sets and combining them to a comprehensive biodiversity assessment is really what's going to be the next step. And then, also, one of the things that we struggle with is we have this great asset location database. But companies don't often disclose all of their locations in all of their operations, or if they do disclose them, they don't disclose them on a granular level. So they'll say what country it's located in or what city, but not its exact location. And really, for understanding impacts on biodiversity, knowing the exact location is hugely important.

Bentley Kaplan:
Yep. It's complex. Biodiversity is no one single metric. Different ecosystems might be measured best in different ways. Something like mean species abundance might oversimplify in some cases will not cover every angle. And until data improves, it will be some unavoidable distance between site specificity and global coverage. There are many driven, smart people that are beefing up biodiversity data as teams like GLOBIO ramp up their efforts and as reporting frameworks like the TNFD take off.

Investors will start finding themselves with a lot more data and far more choice. But time is short, and investors should probably be cautious in thinking that more data will make for simpler decisions. Whether they are guided by frameworks, or conventions, or specific investment mandates, investors will have to roll up their sleeves and get into the thick of biodiversity data, despite the complexity and despite the nuance. But for all of its importance and urgency, it's not likely to be a future with quick wins and clean storylines. And caution about the idea of quick wins and clean storylines is probably a good to start our next story.

On the 12th of June, the electric vehicle company Electric Last Mile Solutions or ELMS announced that it would be filing for Chapter 7 bankruptcy, which is basically the end of the line. Needing to sell off any remaining assets to pay creditors. This announcement has maybe not come totally out of the blue. In March, the company had already laid off 24% of its relatively small workforce in an effort to cut costs.

And those who envisioned a world filled with EVs of all different shapes and sizes, might be disappointed to see ELMS leaving the table. ELMS's ambition was to build and sell EVs specifically for delivery and transport, but even more specifically for the so-called Last Mile. Now that's the short and complex and inconvenient distance between a central delivery hub and the end customer. The Last Mile offers convenience, but has to solve the problem of a multi-ton truck or train, not being able to swing past your doorstep to drop off that novelty mug that you just had to have.

And because we love acronyms, ELMS is also something we are going to call an EV SPAC merger, which translates as an electric vehicle company that listed on public markets through a Special Purpose Acquisition Company or a SPAC. SPAC is basically an empty company, one with no operations. But some SPACS, even though they have no operations, are listed. SPACs can raise capital in the public market and then merge with an unlisted real company. One that actually has operations.

And that effectively allows the unlisted real company to get listed without the pesky administrative hurdles and come with a typical IPO. ELMS in its own SPAC listing went public in June 2021 through a merger with a firm Forum Merger III Corp. Maybe not an inspirational name, but at least accurate regarding ambition.

And we actually spoke to Yu Ishihara from our Tokyo office about EV SPACs on the show about five months ago, in February 2022. And at the time, there was a lot of market excitement about a bunch of new EV SPAC companies that had a lot of enthusiasm and some enticing revenue projections. So once news of ELMS bankruptcy broke, it only seemed appropriate to drag you back in front of a microphone. Now the first thing that struck me about the story was how rapidly the company went from some encouraging investor presentations to owning a factory that could reportedly make 100,000 vehicles to filing for bankruptcy even before rolling out one EV.

Yu Ishihara:
A rather quick turn of events. And this is only just after a year of going public via its SPAC merger. In short, they ran out of money, which may sound surprising given equity investors couldn't get enough of these EV SPAC shares a year ago. But I think I mentioned it last time we spoke about these EV SPACs, let the buyer beware. SPAC mergers circumvent a lot of the requirements of a traditional IPO process which are there mostly for investor protection.

In the case of ELMS, the company ever since listing had a rocky start with their management team resigning, a restatement of all of its previous financials, their auditor resigned earlier in the year. And there's an ongoing SEC investigation into all of these matters. All of these controversies combined, of course, with the challenging macroeconomic environment from COVID-19, supply chain disruptions, and even the Russia- Ukraine conflict led the challenges to finding additional funding. So while the business model itself was probably not the only reason why ELMS went bankrupt, I would point the finger more at governance practices that allowed an EV startup with no track record, access to public markets.

Bentley Kaplan:
Right, so Yu points out that ELMS maybe didn't have the easiest time of it, particularly with supply-chain complications. But there was something nagging a little deeper under the surface of the macroeconomic environment, something in the foundation of the company. And seeing structural issues like executive and order to resignations, and an SEC investigation is not going to inspire confidence, which for me, raised more questions about other companies that like ELMS ran with market enthusiasm about EV startups and listed through the magic of a SPAC merger. Were they having similar challenges to ELMS or is this just an anomaly? And to go one step further in the EV contest between massive market incumbents like Ford or Toyota, are these underdog startups still worthy competitors?

Yu Ishihara:
I would certainly point out that there are significant implications for the rest of the EV SPAC universe, since the troubles that led to ELMS' bankruptcy are not unique. Of the nine other EV SPAC startups currently rated by MSCI ESG research, four of them have ongoing SEC investigations, five of them have issued warnings of going concern at one point or another. And like ELMS, an overwhelming majority of them are yet to be able to deliver vehicles to customers.

And the EV market is no longer about the future anyway. EVs are here now so investors are likely more focused on ability to actually deliver vehicles. Incumbents, as well as the new entrance like Tesla, Neo, or Rivian have all recently launched a flurry of EVs into the market. One could certainly argue that time is running out for those rosy future revenue projections made by these EV SPACs a year ago.

Ultimately, I think the cautionary tale here for investors remains around the promises made by these EV SPACs. Do you believe in their value proposition relative to the competition? And if you do, can they actually execute on their strategy? Even Tesla CEO, Elon Musk, once famously referred to the process of scaling up production as manufacturing hell. Most critically for these EV SPACs, investors need to really reassess whether or not they can get behind the corporate governance and corporate behavior practices, which stem from a relative lack of oversight during the listing processes.

Bentley Kaplan:
Right. So, for some, the words due diligence may be a little dry. A little counter to the spirit of fiery innovation. But in the aftermath of ELMS, and given the current state of EV startups that listed through SPAC mergers of their own, Yu strikes a cautionary tone. And it hasn't escaped the notice of the SEC either. In March, the regulator proposed new rules and amendments for SPACs and shell companies specifically for IPOs that would improve both disclosure and investor protections.

And the words of Gary Gensler, the SEC chair, quote, "Functionally, the SPAC target IPO is being used as an alternative means to conduct an IPO. Thus, investors deserve the protections they receive from traditional IPOs with respect to information asymmetries, fraud, and conflicts. And when it comes to disclosure, marketing practices, gatekeepers and issuers."

And investors will need to have their wits about them. Not only when evaluating niche and prickly propositions like SPAC merger, but in urgent complex topics like biodiversity. Slowing biodiversity loss maybe a challenge like no other starting with a question of data. It's a challenge that is somehow both global and incredibly site specific at the same time. Small differences in location can mean big differences in what's at stake, which particular species or ecosystems are under pressure.

It's true that we can probably expect more and richer data. Companies will be under increasing pressure to report not only their impact, but their risks related to biodiversity loss. And investors will have to trade a fine line. Balancing off the wish for perfect data with the need to act before it all gets too late.

And that is it for the week. A massive thanks to Gillian and Yu for their take on the news with an ESG twist. If you want to get a closer look at the data Gillian was talking about, check out the blog she wrote with Arne, it's available to the public on msci.com with the title “Location Matters Using Geospatial Analysis to Assess Biodiversity Risks.”

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