The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Water as an investment

Companies focused on water supply, demand efficiency and waste management can add defensive growth to portfolios

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There is general agreement that water is important and that its importance is growing. There is less agreement over why water is important.

Misconceptions about water are widespread. Perhaps the most common is that water is scarce. However, from the perspective of space, the Earth might appear to have too much water rather than too little. The issue is local, rather than global.

Other misconceptions include the idea that 'wet' countries can't be water-stressed. And yet, the UK – a pretty wet country by most measures – may run out of water in 20 years according to the UK's Environment Agency because of population growth, lack of storage infrastructure and climate change.

And then there's the concept that water challenges mainly reside in emerging markets. While that idea may have legitimacy if we are talking about kilometres of pipes, consider the cost of replacing 250-year-old water and sewerage pipes in New York City, one of the most densely-populated urban areas in the world.

In other words, there is confusion regarding the definition of what water issues actually are, how they can be addressed and whether the solutions represent an investable theme.

What are our water issues?

Water issues relate to the global imbalance between water demand and water availability. To address this challenge, solutions can be broken down into three segments, according to Arnaud Bisschop, a founder and owner of Thematics Asset Management, an affiliate of Natixis Investment Managers. These are demand efficiency, pollution control and water infrastructure.

Of the three, **demand efficiency** is the highest growth segment as water users in many parts of the world adapt to increasing water constraints. Consumers, industry and farmers are all striving to reduce water consumption to mitigate increasing competition for water resources.

A growing number of companies are developing technology-led services and equipment to increase efficiencies. These range from domestic showers and irrigation systems, to solutions for heavy industries such as oil and gas and agriculture. Bisschop says: "Farmers are heavy users of water but pay little for it, so have little incentive to improve efficiency. Companies have to be highly innovative to address that kind of challenge."

The second segment, **pollution control**, is about measuring pollution and managing waste. Professional waste management service businesses, for instance, are seeking ways to prevent water table pollution. Pollution monitoring equipment is now deployed across the globe to track water flows and facilitate effective enforcement of increasingly strict water quality standards.

Key takeaways:

- As an individual or a company, the availability and quality of water is going to directly impact your life, even more so than CO_2 emissions.
- Water is not investable as a commodity, but investors can take stakes in companies that focus on water demand efficiency, water infrastructure and pollution control, and have strong ESG profiles.
- Water-focused companies are a $800bn a year market, projected to grow at 6%-8% annually, with a combined market capitalization of more than $3 trillion.

The last segment, **water infrastructure**, focuses on the catch-up of decades of underinvestment in existing water infrastructure assets of Developed economies and on putting new systems in place in high-growth emerging markets. Urbanisation drives the increased demand for this new water and wastewater infrastructure, while systemic failures, leakage and even pollution scandals provide some of main drivers for water market growth globally as refurbishment spending requirements climb ever higher in developed countries. Meeting water infrastructure supply challenges includes building and managing utility networks, while municipal authorities increasingly hire concessions operators to run water services. Meanwhile, technology providers are developing both basic and sophisticated components to help plug gaps in water infrastructure. Investments are also required to improve the treatment of water to tackle a rapidly increasing number of water contaminants, as well as to comply with stringent regulations.

Investing in water as a theme

So what, exactly, is the investment opportunity? "It is not uncommon for people to think that the opportunity is to buy water, the physical commodity," says Simon Gottelier, a founder and owner of Thematics Asset Management. There is no cohesive single market for water, but there is a market for the kinds of services described above. "It is a pretty diversified universe, with close to 300 global companies that fit into these three segments," says Gottelier

This universe of companies now represents a $800bn a year market that is expected to grow by 6%-8% annually, with these companies having a combined market capitalization of more than $3 trillion.

The wide and diversified opportunity set means that, over extended time periods, some drivers of value will surge and offset lower growth or falling values from other parts of the market. In the last two or three years, for instance, the biggest overall driver has been the pollution control segment, as Covid put the spotlight on water quality assessments and the quality of water used in healthcare applications relating primarily to covid testing.

.How to assess water-themed stocks

Thematics employs discrete teams to focus on each of the three main segments. These teams track the big macro changes and relate them to business activity at each of the 300 companies in the universe.

In recent times, inflation has been a preoccupation of many macro analysts. Given that regulated water utilities are one of the few types of companies that are able to pass on higher prices in full, utility holdings, for example, should be able to maintain or increase their market value.

Following the progress of the US Infrastructure Investment and Jobs Act is also important to see which infrastructure will be supported and which companies stand to benefit from providing services and equipment to deliver it. The Act provides the largest investment in clean drinking water and wastewater infrastructure in US history.

The Thematics teams also assess water-focused companies on fundamental criteria, such as the quality of the business model, the management team, the composition of existing shareholders, stock liquidity and current valuations.

"In terms of value, we have a long-term approach and look for a visibility premium that the market is not currently recognising or pricing appropriately," says Gottelier. "Our companies are exposed to drivers that can deliver higher levels of growth that the market has not recognised." Often the companies are small or mid-caps and are not household names, meaning they are under-researched by most buyside analysts.

Companies that fulfil Thematics' criteria for investment include Clean Harbors, a US company which manages hazardous industrial waste, provides an emergency response to accidental pollution and recycles used oil. Its prospects have been buoyed by strengthened environmental regulation under the new US Administration. Meanwhile, Stantec, a Canadian environmental consultancy business, specialises in water and environmental projects, with a particular focus on infrastructure. It has 50% exposure to the US and is expected to benefit from the Infrastructure Act.

Thematic maintains ongoing discussions on strategy, governance, risks and regulation, as well as on issues such as how a company treats its suppliers and manages its supply chains. This applies to a range of companies in the universe, including many not actually in the portfolio. "Many are happy to develop a dialogue because this is a like-minded community and we all benefit from each other's insights," says Gottelier.

Water investing exhibits natural ESG bias

As would be expected from a strategy based on conservation of natural resources, ESG is an important factor in stock selection. "What we do connects directly to climate change," says Bisschop. "It's often been said, if climate change was a shark, water is the teeth. As an individual or a company, it is not CO2 which is going to directly impact your life or your business, it is the availability and quality of water. It's the water that will bite you."

As such, the central aim for Thematics is to improve the quality, supply and efficiency of water across the globe. Carbon reduction is on the radar, but regarded as a component of the E, S, G continuum. "We select the stocks that have best potential returns and diversification properties" says Bisschop. "We want them to have a lower carbon footprint than the index if possible, but given that carbon measurement is backward-looking, that is not a key focus."

The water-related investable universe as a whole has a relatively high carbon footprint. To move, treat and get more water from processes such as desalination, requires energy so carbon emissions for the universe are higher than for broad indices. Thematics seeks companies that have well-structured plans to contribute going forward to the net zero goal. "We are looking for commitment rather than great carbon scoring right now," says Bisschop. He points to Severn Trent, a water company in the UK's Midlands, as an example. It has, he says, one of the most elaborate plans anywhere to address the challenge of getting to net zero. "For us, a forward-looking perspective is critical," adds Bisschop.

Defensive growth across the cycle

The investable universe is condensed by Thematics to 50-60 companies, with the aim of outperforming broad indices by around 200bps-300bps a year without actually tracking an index. The active share is close to 100%, reflect the different dynamics of water-focused companies versus mainstream indices.

Bisschop says: “One of the unique points about a diversified water strategy is that outperformance can materialise in both strong and weak markets, providing alpha continuously over the cycle.”

The approach provides investors with defensive growth over the long term given this diversification and the correlation with long-term demographic drivers. Water is a natural resource which is in high demand no matter the prevailing macro-economic winds. And because water-themed assets are often real assets, or directly-linked to real assets, they can be effective inflation hedges.

“We think this is a suitable offering for investors who want to contribute globally to the sustainable use and protection of water resources, while generating long-term growth through an investment process which systematically incorporates ESG,” says Bisschop.

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