WATER RISK OFTEN IGNORED BY MAINSTREAM INVESTORS
DESPITE BEING ONE OF THE FIVE BIGGEST THREATS TO GLOBAL ECONOMIC STABILITY

Needs to be systematically integrated into the investment process

Water issues also offer big opportunities for investors given the infrastructure spending required and the need for private capital to play a strong role

London, 5th November 2019 - Water risks are often ignored by mainstream investors despite being cited by the World Economic Forum as one the five biggest threats to global economic and political stability. Sectors most at risk include agriculture, food and beverages, energy, oil and gas, chemicals and mining. We believe investors need to integrate water risks systematically into the investment process to be able to assess properly the return potential of companies in these sectors.

Water does not only represent risk but also offers big opportunities for investors given the infrastructure spending required and the need for private capital to play a strong role. The World Bank estimates that delivering the UN's Sustainable Development Goal 6 by 2030 will require over $100bn of additional capex globally every year on infrastructure and further development, circa 40% above current spending.

These are the conclusions of Edison Group's latest research report into the sector, 'Water – the real liquidity crisis.'

Water risks present widely and are multifaceted

Only a small fraction (2.5%) of the global water supply exists as freshwater. An even smaller proportion (0.025%) is accessible as surface water. This water is unevenly distributed and its availability is neither predictable nor constant over time. Quality is an issue as much as quantity: pollution, either by nitrates, biological material or heavy metals, can further restrict availability.

Demand for water is rising globally (c.2% annually), predominantly driven by regions where the population is growing. The amount needed for drinking is just a fraction of this demand. The WHO estimates the average person requires just 2-3 litres per day for drinking. In contrast, residential consumption in developed countries is 100-300 litres per day. Substantial water resources are needed for cooking, washing, cleaning and sanitation. In addition to this, water is consumed 'indirectly', embedded in energy and particularly food production.

Shifting patterns of demand and supply are creating both acute and chronic water issues. The UN estimates that 800 million people (10% of the global population) don't currently have access to clean water and a further 3.2 billion (40%+) face severe water shortages at least one month a year. It is estimated that by 2030 population growth will see global demand for clean water exceed supply by 40%. Half of this growth is expected to be in Africa, a region with limited surface water resources. Meanwhile, rapid urbanization is leading to acute shortfalls for many cities. China's industrialization has driven dramatic increases in both demand and water pollution.

..and yet water risks are rising

Water risks are acute for certain sectors but are often ignored by investors who may regard them as long-term issues. Agriculture, food and beverages, energy and mining disclose these risks, which include floods and droughts, but they can no longer be discounted as one-off events. Their complexity and location-specific nature makes them difficult to assess and integrate into the investment process. When evaluating the different levels of risk water could bring into a portfolio, investors should keep three key considerations in mind. Ceres, a non-profit organisation focusing on encouraging investors to address sustainability, has created an investors' water toolkit to help asses water risks. They highlight:

Physical risk - This not only includes potential disasters such as droughts or flooding but also lack of proper infrastructure or a declining supply.

Regulatory risk- In the current uncertain global political environment, policy changes by incoming governments or unexpected increases in tariffs pose a threat that investors should bear in mind.

Social/reputational risk – These revolve around potential sanitation violations, community blocking of current/planned operations and customer/workforce perceptions.

Integrating water risk into the investment process

These considerations are not comprehensive but illustrate, in our view, the need for investors to integrate water risks systematically into their decision making. Cares's toolkit highlights 3 main risks when integrating water into an investor's portfolio:

- *Assessing corporate risk:* Investors need to understand fully water's dependency risk. Analysis of the intensity of production, integrating an academic approach, applying a shadow water price and assessing management's response to risk are vital before integrating water investments into a portfolio.
- *Integrating into decision process*: As with any investment, due diligence is key. Investors need to carry out a screening process to define the material risk to absolute or relative performance.
- *Full Portfolio integration*: It is vital for investors to carry out a standardized assessment approach and integration across products as well as integrating this into strategic decision making and in marketing to external investors.

Water presents an opportunity

Water issues also present a big opportunity for investors. Closing the projected gap between global demand and supply requires new infrastructure in developing countries while developed countries (notably the U.S.) urgently require upgrades to improve wastewater treatment and cut leakages. At the current stage, circa 40% above current spending is still required.

In the U.S., the Green New Deal, supported by the majority of US Democratic candidates for 2020, promises to tackle this and guarantee "universal access to clean water". These upward pressures on spending are the reasons many analysts characterize the long-term fundamentals of the water market as "compelling".

Infrastructure projects are highly suitable for debt financing. It is estimated that annual private sector infrastructure debt financing in the water sector ranges from $17–40bn. However, the vast majority of this is directed to projects in developed countries. The rapid rise in green/climate bonds (over

$200bn issued in 2018) combined with tax incentives and explicit environmental goals could prove to be potentially significant. However, as formal 'use the proceeds' requirements were only adopted in May 2018, few water-specific green bonds have been issued to date. Environmental Finance estimates just over $3bn sustainable water management green bonds have been issued in the U.S. in 2019 so far.

How to play the water theme

For equity investors attracted by the water market a range of vehicles are available. Many fund managers have now launched thematic water products. Some, such as Pictet Water, exclusively focus on capital growth, others incorporate (non-financial) objectives and aim to be "sustainable" (e.g. Fidelity - Water and Waste) whilst others have explicit impact mandates (Impax – Water Strategy). For investors seeking to minimize management fees there are also an increasing range of ETFs available. Assessing the (gross) performance of a sample universe of funds, most have sustained an average growth of over 6% over the last five years with managed funds achieving over 10%. Investors can also, alternatively, take direct stakes in companies targeting the water sector.

Dan Gardiner, Director at Edison Group said:

"The water sector presents big opportunities for investors. Huge spending increases are needed over the next decade to both address underserved communities and upgrade existing infrastructure. The sector is particularly attractive to income funds and the growing pool of capital looking at sustainable and impact strategies. More broadly, looking at investments in a range of other sectors, water risks need to be assessed more seriously and systemically integrated into decision-making processes to ensure that investors maximise their potential returns and achieve their investment goals."

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