

# Water investment strengthened by global

**Steve Falci** of KBC Asset Management looks at how the water investment sector is set to grow leading to long-term investment potential

“A crisis is a terrible thing to waste.” This admittedly over used quotation has been attributed to US President Obama’s chief of staff Rahm Emmanuel, to describe the opportunity to construct policy to address the most significant financial crisis in generations while addressing society’s longer term challenges. Nowhere has this been more evident than in the massive global fiscal stimulus packages where significant components are directed toward “green” initiatives designed to contribute to the foundation for a more sustainable future. While essential climate mitigation efforts have received the most attention, significant global stimulus has also been directed toward addressing water scarcity.

Water scarcity has increasingly entered global consciousness over recent years. A growing more affluent, world population (particularly in cities and in developing countries) has put increased stress on the finite supply of water. Climate change is also affecting the supply of freshwater, as rising temperatures and altered precipitation patterns could result in increased drought conditions throughout certain parts of the world. The United Nations estimates that two-thirds of all nations will become “water stressed” by 2050, with close to two billion people living in countries facing “absolute water scarcity”<sup>1</sup>.

The global trends of population growth and changing demographics, the accompanying pressure on the



supply of clean water and climate change are sustained drivers of significant investment to provide access to clean water over the course of the 21st century. Consultant Booz, Allen, Hamilton projects that between 2005 and 2030, investment in projects benefiting companies providing water solutions will be approximately US\$22trn, representing the largest component of global infrastructure investment over that period.<sup>2</sup> Thus, the prospects for companies that are positioned to manage water demand and improve access to safe water appear bright and profitable over the long-term.

## A long-term view

These global trends provide strong support for the long-term prospects for investments in water and are reinforced in the near-term by fiscal stimulus funding directed toward investment in water. Global fiscal stimulus packages



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have surpassed the \$3trn level, with a little more than \$500bn targeted toward “green” initiatives. Approximately, 16% of these funds (nearly \$80bn), are directed toward water projects, with the majority of government spending focused on water being deployed in China (\$34bn) and the United States (\$20bn). However, while many of these stimulus packages were announced early this year, by mid-year, only 3% of the funds allocated to green targets globally had been spent.<sup>3</sup>

Nowhere is this delay more evident than in the anticipated spending on water infrastructure and technology in the United States through funds designated in the American Recovery and Reinvestment Act (ARRA). Approximately \$11.8bn of the \$15bn ARRA earmarked for water funding is to be administered by the US Army Corps of Engineers or the Environmental Protection Agency (EPA) for investment in water infrastructure projects. As of mid-August only 2% had been deployed.<sup>4</sup> While administrative delays account for both the actual delays and perhaps delays in reporting, the bulk of the spending will impact investments in 2010 and 2011. Companies receiving EPA allocations must have signed contracts or commencement of construction by February 2010, which indicates an acceleration of the deployment of funds later this year and in early 2010. Overall we believe this is very positive for water infrastructure stocks providing water treatment systems, pipes and pipelines and consulting and engineering services in the US.

Water technology stocks providing smart metering are also expected to be

## Investment in the water sector

**Water & Wastewater Utilities** Water utilities can provide a wide variety of products and services ranging from collection and distribution of water to treatment and monitoring of water. Utilities should benefit from the rising demand for infrastructure improvements, a heightened focus on recycling wastewater for use by industries and farms, and the continuing trend toward outsourcing and consolidation.

**Water infrastructure** These diversified companies can provide products and services to distribute water over larger areas, fix leaks, or conserve water. They comprise a wide range of specialties, from fluid control equipment, pumps, seals, valves and pipes, to design,

construction and engineering solutions. Companies in this sector are positioned to benefit from the need for massive investment over the next 20 years to address the needs of the aging water infrastructure and provide new infrastructure.

**Water technologies** Water technologies help filter, purify, separate, and desalinate water and otherwise make it safe for use. Water metering is another rapidly growing technology that facilitates increased conservation and efficiency in water usage. Consolidation will be a factor in this sub-sector because some larger conglomerates will look to acquire specific technologies they currently lack.

# trends & current market environment



positively impacted by stimulus funds in the US. Smart metering plays a key role in increasing efficiency of water use through more accurate measurement of usage that helps improve water conservation. It is probably the most mature component of the water technology sector, providing investors with the broadest opportunity for investment in the near-term. It is expected that this is one area in which US States receiving allocation for water projects will deploy the funding. California has tentatively allocated about 25% of its \$160m for drinking water projects to 10 metering projects. If most states allocate even 5% to 10% of their allocations to meters, it would represent a significant boost to the market for meters over the next two years.<sup>5</sup>

## Looking east

China is directing a significant portion of its green stimulus to continue its broad efforts to provide clean water, a major challenge China has been addressing amid its growing population and increased industrialisation. Stimulus is focused on a myriad of infrastructure needs including reservoir development, provision of drinking water in rural areas and support of the "south to north" water project that is designed to transport water from areas in the south where there is an over supply to cities in the north that suffer from drought. Waste water treatment will also get a boost from the Chinese stimulus package, with water technology companies providing treatment technologies including membranes, chemical treatment and desalination poised to benefit. Chinese companies, as well as well positioned international companies, in both the water technology and water infrastructure sectors have the opportunity to benefit from this spending.

In addition to these near-term efforts that support investment in water, the current market environment provides a particularly attractive entry point for new investors in water as we emerge from the financial crisis. The severe downturn in markets during the crisis in the latter half of 2008 was particularly hard on many water stocks amid concerns relating to credit. Despite the

<sup>1</sup> Water: Oil Companies See Opportunity in Another Precious Commodity," Greenwire, July 2008

<sup>2</sup> Nikko Citi, "Global Infrastructure Investment Growing" – September 2009

<sup>3</sup> HSBC Global Research, "A Global green Recovery? Yes but in 2010" – August 2009

<sup>4</sup> Janney, "Water Infrastructure Spending Update- Anybody feeling Stimulated Yet?" August 2009

<sup>5</sup> Pipe Jaffray, "Getting "Smart" in the Water Space" July 2009

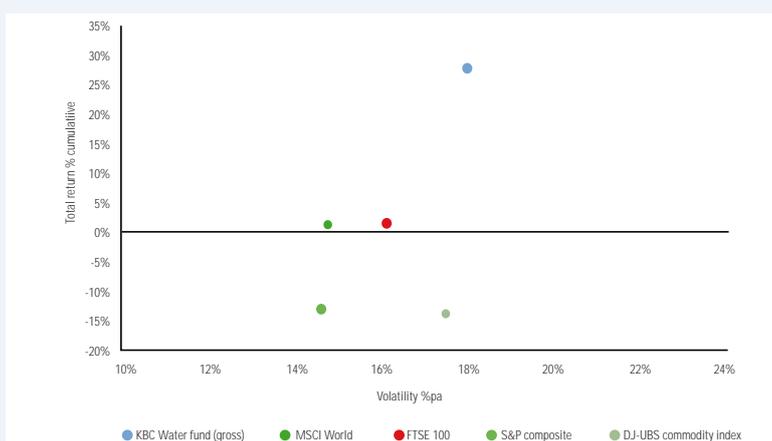
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## Water's place in a global equity portfolio

Investors have identified various roles that water stocks can play in a global equity portfolio. It can be included as a unique source of secular growth, a more defensive component of a growth allocation or as part of an infrastructure allocation derived from the port-

folios exposure to water infrastructure and utilities. Wherever investors have chosen to place water in their equity allocation, over the last five years it has provided significant returns above the broad market while only taking on marginally more risk.

Chart: risk/return comparison five years to August 31, 2009



Source: KBCAM & DataStream (gross returns expressed in euros)

broad rise in the market as well as in water stocks since mid-March, many water stocks are still trading at very attractive valuations. At the end of August KBC Asset Management still regarded our Water portfolio as undervalued, as its aggregate P/E was only slightly above the broad market as measured by the MSCI World Index.

Such valuations we believe are not reflective of both the earnings potential over the next few years and more importantly, the secular growth opportunities over the coming decades. In the near-term, we expect many companies to benefit from cost cutting undertaken in the wake of the crisis and are poised for stronger profitability as business picks up. More importantly, leaner more fundamentally sound companies that are strategically well placed for leadership in their particular areas of water technologies, services and infra-

structure have the potential to provide strong returns relative to the broad equity market over the long term.

While the financial crisis may have created a very productive opportunity to support investment in water and stimulate the economy over the near term, these stimulus efforts should be properly viewed as a harbinger of evolving support from governments, as well as our broader global society, for concerted efforts to address water scarcity over the coming decades. Supportive water regulation and/or longer term funding commitments in Asia, the US and across the European Union all point to sustained efforts to encourage investment in water technology and infrastructure over at least the next decade. The ability to gain exposure to this secular growth theme at attractive valuations we believe presents an excellent opportunity for long-term investors. ■