

# More valuable than oil – The investment case for water

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That bottle of water on your desk likely costs many times more than its equivalent in gasoline. No wonder that, historically, investments in water have generally outperformed global indexes. But first, a little background.

Almost all of the water on earth is salt water with only about 2.5% considered fresh. Of this, less than 1% is accessible surface water<sup>1</sup>. In many areas, the water is polluted, exacerbating the supply constraint. Additionally, while fresh water supplies are relatively static, global populations are expected to increase from less than 7 billion to 9 billion by 2050<sup>2</sup>. And much of this population growth is occurring in developing economies where access to fresh water is much more limited.

Under a current business as usual scenario, by 2030 water demand will outstrip supply by 40%. By 2050, this fresh water deficit has the potential to put \$63 trillion or 22%<sup>3</sup> of global gross domestic product at risk<sup>4</sup>. In response to this unsustainable trend, governments and businesses must plan and implement long-term solutions to address water scarcity and quality issues through improved water conservation, treatment, re-use and desalination facilities.

## Potential for strong, long-term growth

The investment opportunity surrounding this growing global supply/demand imbalance is underpinned by four drivers:

- In developed markets, substantial investment is needed to upgrade aging infrastructure, and the costs of doing so are rising steeply. Cumulative water infrastructure spending requirements are expected to exceed \$23 trillion by 2030<sup>3</sup>.

<sup>1</sup> www.fao.org, Dimensions of need – water: a finite resource.

<sup>2</sup> EIRIS Water Risk Report, June 2011.

<sup>3</sup> WATER: Oil Companies See Opportunity in Another Precious Commodity,” Greenwire, July 28, 2008.

<sup>4</sup> Booz Allen Hamilton, Global Infrastructure Partners, World Energy Outlook, Organization for Economic Co-operation and Development (OECD). Boeing, Drewry Shipping Consultants, US Department of Transportation.

## KEY TAKEAWAYS

- Investment opportunities surrounding the growing imbalance between the supply of, and demand for, water underpins a 10-year annualized record of out-performance by the S&P Water Index compared to the MSCI World Index with comparable levels of absolute risk.
- Companies active in the global water market are approaching \$500 billion in revenues and growing at a rate of approximately 7% per year.<sup>5</sup>
- Investors can select from a wide range of opportunities across three main sectors of the water value chain: water infrastructure, water treatment and water utilities.
- Investing in listed equities, as opposed to private equity, across the water value chain offers the potential for investor benefits such as liquidity, transparency, a diversified investible universe, and access to early-cycle, mid-cycle and defensive positions across a range of regions and countries.

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- Water demand is rapidly increasing in developing economies where rising population and urbanization is requiring massive investment in water infrastructure.
- Stricter water quality regulations to address pollution are driving investment in water treatment facilities, particularly in China and India.
- Changing weather patterns are making it rain harder where and when it does rain, requiring significant investment in storm water systems and pumping stations.

As a result, companies active in the global water market are approaching \$500 billion in revenues growing at a rate of approximately 7% per year<sup>5</sup>. Not surprisingly, merger and acquisition (M&A) activity has been robust and much of that activity has been dominated by global companies looking to expand their businesses through bolt-on acquisitions of innovative technologies. Siemens AG, 3M Co. and General Electric Co.<sup>6</sup> have acquired companies in the water market, with GE's acquisition spree including BetzDearborn Inc. and Osmonics Inc. (water treatment), Ionics Inc. (desalination) and Zenon Environmental Inc. (membranes)<sup>7</sup> as part of its move into the sector. M&A activity is anticipated to continue, as large-cap companies with access to low-cost capital seek companies with niche water technologies such as advanced treatment and filtration applications.

### The value chain

Investors can select from a wide range of opportunities across three main sectors of the water value chain:

- Water infrastructure companies can provide steady growth on a global basis and up to 20% in some developing markets<sup>8</sup>. Businesses range from pumps, pipes and valve manufacturers to companies supplying equipment for irrigation and infrastructure projects.
- Water treatment companies typically offer high levels of profitability and steady growth profiles. High value-added products, such as desalination membranes or advanced treatment technologies command higher margins and offer a greater degree of earnings visibility because of steady demand for critical products in existing processes. With increasing demand requirements from growing coastal communities, desalination is a key area of growth.
- Water utilities are defensive in nature because of stable cash flows and attractive dividends.

### Diversified and balanced portfolios

Investing in companies across the water value chain can provide investors with a diversified and balanced portfolio regardless of the point in the economic cycle. For instance, a portfolio weighted toward water utilities, with their stable cash flows and high dividends, offers mitigation against volatile markets. Alternatively, water infrastructure companies are highly correlated to the cyclical construction markets. Water treatment companies provide attractive growth

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<sup>5</sup>Citi Group Global Markets, "Water Sector Handbook", 24 May 2011

<sup>6</sup>As of 11/29/13 the Pax World Global Environmental Markets Fund held 2.3% of 3M Co., Siemens AG and General Electric Co. were not held by the Fund. Holdings are subject to change.

<sup>7</sup>As of 11/29/13 BetzDearborn Inc., Osmonics Inc., Ionics Inc. and Zenon Environmental Inc. were not held by the Pax World Global Environmental Markets Fund. Holdings are subject to change.

<sup>8</sup>BOC International research report on China Everbright International, Jan. 9, 2009, p. 3

opportunities in developing markets where growth exceeds global averages.

Investing in water has rewarded investors with strong returns. For the 5 year period through September 30, 2013 the S&P Water Index<sup>9</sup> has outperformed the MSCI World Index<sup>10</sup> by 1.84% annualized, with comparable levels of absolute risk<sup>11</sup>.

### The case for listed equities

Historically, investors have targeted resource demand opportunities by allocating private equity capital to real assets and infrastructure projects or by investing in commodities. This is familiar territory. However, investing in listed equities across the global water value chain presents several potential benefits to investors:

- Listed equities generally provide greater liquidity and transparency than private equity or commodities.
- The investible water universe, representing approximately 300 public companies globally, is wide and deep, allowing investors to build diversified portfolios.
- Listed equities provide access to early cycle, late cycle and defensive positions across the water infrastructure, treatment and utilities sectors, and across a range of regions and countries.
- Assessing the intrinsic value of specific stocks is not nearly as complex or onerous as the due diligence required to value specific private assets.
- Share prices of many companies active in the water market remain attractively priced on average given their above market earnings growth rate and high enterprise value compared to invested capital.

### Conclusion

Like the oil boom last century, we believe there are many rich investment opportunities in this century's water boom. The global availability of accessible, clean water is finite and under considerable strain, and the growing gap between supply and demand will continue to fuel the need for more efficient technologies in water infrastructure, treatment, and utilities. The growing supply/demand imbalance is creating demand for a variety of solutions, and the water sector will need substantial capital investment across all subsectors, presenting investors with numerous, attractive long-term, global opportunities.

*The statements and opinions expressed are those of the author of this report. All information is historical and not indicative of future results and subject to change. This information is not a recommendation to buy or sell any security.*

<sup>9</sup>The S&P Global Water Index provides liquid and tradable exposure to 50 companies from around the world that are involved in water related businesses. To create diversified exposure across the global water market, the 50 constituents are distributed equally between two distinct clusters of water related businesses: Water Utilities & Infrastructure and Water Equipment & Materials.

<sup>10</sup>The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The MSCI World (Net) Index consists of the following 24 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. Performance for the MSCI World Index is shown "net", which includes dividend reinvestments after deduction of foreign withholding tax.

One cannot invest directly in an index.

<sup>11</sup>Volatility and/or risk is measured by standard deviation. Standard Deviation measures a Fund's variation around its mean performance; a high standard deviation implies greater volatility. For the 5-year time period 10/2008 to 9/2013 the annualized standard deviation for the S&P Global Water Index was 19.62% and the MSCI The World Index (Net Return) was 19.55%.

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## Impax Asset Management Ltd.

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