

Water & Waste Investments, a defensive growth opportunity for uncertain times

A growing population, aging infrastructure, the importance of ESG: is water the new place to be? We take a closer look with Simon Gottelier, Partner and Senior Portfolio Manager at Thematics Asset Management, an affiliate of Natixis Investment Managers.

By Harry Geels



Simon Gottelier

Partner and Senior Portfolio Manager, Thematics Asset Management (an affiliate of Natixis Investment Managers)

Why is water an important investment theme?

‘As an individual or a company, the availability and quality of water will probably directly impact your life, even more so than CO₂ emissions. There are many misconceptions about water. For instance, it is commonly said that water is scarce. However, an astronaut would tell you there is plenty of it on earth. We see water as a local, rather than global, issue.

Another misconception is that rainy areas can't be water-stressed. However, the UK – a relatively wet country – may run out of water in 20 years, according to the UK's Environment Agency, due to population growth and poor water storage infrastructure, as well as climate change. And consider the substantial costs of renewing 250-year-old water and sewerage pipes in New York, one of the most developed cities in the world.

In other words, water challenges definitely aren't confined to emerging markets. The challenges are all around us.'

What issues can be solved by water investments?

‘Water needs can be broken down into three themes: demand efficiency, water infrastructure demand, and pollution control. Of the three, demand efficiency is the fastest-growing need, as water users in



many parts of the world face increasing water constraints.

In terms of water demand, a growing number of companies are developing technology-led services and equipment to increase efficiencies. These range from domestic shower and irrigation systems to solutions for heavy industry, such as oil & gas and agriculture. Companies and investors have to be highly innovative to address the challenges. Farmers, for example, are heavy users of water, but pay little for it, so they have little incentive to improve efficiency.

Developed economies have endured decades of underinvestment in their existing water infrastructure assets. Meeting water infrastructure supply challenges requires the building and managing of utility networks. Meanwhile, technology providers are developing solutions to help plug gaps in water infrastructure.

Pollution control is about measuring pollution and managing waste. Professional waste management service businesses, for instance, are seeking ways to prevent water table pollution. Monitoring equipment is now being deployed across the globe, to track water flows and facilitate enforcement.'

Can water investments help accelerate climate transition?

‘As expected from an investment strategy

based on conservation of natural resources, ESG is an important factor in stock selection. However, the water-related investable universe 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.

That doesn't mean that nothing can be done. We seek companies that have well-structured plans to contribute to the Net Zero goal. We look for commitment rather than a great carbon score.'

Are there enough public investable water companies to address the issues you mentioned before? Is the market big and liquid enough?

'The universe of water-themed companies now represents an \$ 800 billion a year market, and is expected to grow by 6% to 8% annually. It is a diversified universe, with close to 300 global companies that fit into our three investment themes. These companies have a combined market capitalization of more than \$ 3 trillion.¹

The wide opportunity set means that over extended time periods, some drivers of value will surge and offset stagnant or falling values from other drivers. In the last two or three years, the biggest driver has been the pollution control segment, because the COVID pandemic emphasized water quality assessments and the quality of water used in healthcare applications.'

How do you select the right companies for your water-themed portfolio? Are water-themed investments suitable for institutional investors?

'We employ discrete teams to focus on each of our three investment themes. These teams track the big macro changes and relate them to business activity at each of the 300 companies in the universe.

We follow the progress of the US Infrastructure Investment and Jobs Act to see which infrastructure will be supported and which companies stand to benefit. The Act provides the largest investment in clean drinking water and wastewater infrastructure in US history. We 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 isn't currently giving to stock. Our companies are exposed to drivers that can deliver higher levels of growth, that the market hasn't recognised. Often the companies are small or midcaps and aren't household names, meaning they are under-researched by most buy-side analysts.

Companies that fulfil our 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 improved by recently-enacted environmental regulation in the US. Another is Stantec, a Canadian environmental consultancy business. It 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.

We think investing in water-themed companies is suitable 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.'

Is it currently a good time to buy water-focused companies?

'In recent times, inflation has been a pre-occupation. 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.

Also, because water-themed assets are often real assets or linked to real assets, they can be effective inflation hedges. Inflation aside, one of the unique points of a diversified water strategy is that out-performance can materialise in both strong and weak markets, providing alpha over the cycle. Our approach leverages the diversification available in the sector and the correlation with long-term demographic drivers to focus on defensive growth over the long term.' ■

¹ Source: Thematics Asset Management

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SUMMARY

Water needs can be broken down into three themes: demand efficiency, water infrastructure demand, and pollution control.

The universe of water-themed companies is an \$ 800 billion a year market growing up to 8% annually, comprising around 300 companies.

Regulated water utilities are one of the few types of companies that are able to pass on higher prices in full.

A diversified water strategy can outperform in both strong and weak markets, providing alpha over the cycle.