

# MARKET COMMENTARY

## UK Water Investments, 29<sup>th</sup> June 2023.

There has always been a good impact case for investments that improve water infrastructure, especially where there is a genuine need. Access to a source of reliable and clean water is essential for human development, as is the safe removal of waste water and sewage. Whilst this is something we take for granted in much of the developed world, it remains a serious issue in many other places. So much so that it is a key UN Sustainable Development Goal (SDG), with Goal 6 aiming to “Ensure availability and sustainable management of water and sanitation for all”.

The English and Welsh water industry was largely privatised in the early 1990s. Most of the original 10 water companies were subsequently acquired by private equity investors which left only three of them remaining as public listed companies.

The UK water sector has made headlines for a number of reasons. These essentially boil down to allegations of poor management in the forms of underinvestment and overleveraging debt which has been used for paying excessive dividends. This has resulted in high leakage rates, appalling and unacceptable sewage and waste water management, and financial weakness. In the last couple of days these issues have started to come to a head at Thames Water.

Given the mature and (on a global scale, despite the above) relatively good state of water in the UK, we have always considered the UK water utilities as potential ESG investments rather than genuine impact investments. In essence this means we would invest in a developed world water company if the company had high Environmental, Social and Governance Standards, above those of its peers which was recognised as such.

In our bespoke portfolios, where we choose the underlying investment directly, this meant we invested in Severn Trent Water (a UK water utility) and the Bazalgette bond. We also have indirect exposure to Bazalgette equity via the infrastructure fund International Public Partnerships (INPP).

Severn Trent, with headquarters in Coventry, is the main UK water utility for Central England. Over the last 21 years we have invested in Severn Trent a number of times. Our last investment was made in November 2020 when we added equity back into portfolios. From an ESG rating perspective they had an MSCI rating of A (now AA). ESG ratings are only a small part of our consideration, and an additional factor was their high rating by OFWAT. We noted strong credentials in active water stress programs and carbon emission reduction, whilst they were already active in biodiversity and environmental programs. Good governance was also important with strong management by Olivia Garfield. Whilst not perfect, to us they remain a clear leader in this important sector. On valuation grounds we sold the equity at the end of 2022 but in lower risk portfolios we added the bonds. Being publicly listed the company is under considerably more scrutiny than the now privately held peers and the bonds remain investment grade.

Bazalgette is the Tideway (London super sewer) project and has close links to Thames Water. This was a fixed income and infrastructure investment in portfolios, serving an important environmental and

social need to modernise and improve waste water infrastructure in London. This would be part of the solution to waste water and sewage issues. Whilst the tideway revenue is paid for by Thames Water clients and collected by Thames Water, it is a separate company and not part of Thames Water.

In our model portfolios, where funds are held, water bonds feature to various degrees in the bond funds. Here exposure to Thames Water varies, but the bonds are held in the regulated utility rather than the parent company and therefore remained unaffected by the current issues.

On the equity side, we hold water funds (Pictet Water/Legal & General Clean Water) and this will include holdings in the three remaining UK water utilities (Severn Trent, United Utilities and Pennon) as well as other global water utilities and water-based companies. Many of the other companies are involved in ensuring clean and safe water around the world.

The current issues in the UK remain, a lack of infrastructure investment and high levels of debt. UK water is more complex than just the water companies, its highly regulated and we also feel the regulator and government need to be more active. The complex private ownership of some of the water companies highlights the need for more transparent business practices and for shareholders (whether public or private) to remember ownership is more than just taking cash flows.

Whether it's the developed or developing world, the water sector requires capital and expertise. On the model portfolio side, we have engaged with fund managers who hold the bonds, on the bespoke side our ESG process and impact emphasis has led to the focus on the better performers for a general utility and more solution-based investments with the Tideway project.

When selecting investments, we always remain vigilant that we meet the ESG and Impact criteria, as well as the financial criteria.

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