Fidelity INTERNATIONAL

WATER & WASTE SERIES
Part 1

An industrial view of our most precious asset: WATER

- Issues around water are complicated: 1% only of the water on Earth is fit for human needs. But amid growing populations and commercial activity, the demand for that one per cent continues to rise.
- Concerns around water - and more broadly environmental, social and governance factors (ESG) - have a tangible and direct impact on valuations.
- ESG considerations shine a light on where risks lurk in the depths of a company's operations. This approach is core to investing in equities but indispensable to bond analysis. Missing an ESG risk can easily lead to losing a chunk of value, particularly on a highly leveraged bond. On the other hand, critically analysing ESG risks can help avoid the losers (as well as spot the winners).

Utilities: Walking on water

Utilities are one of the oldest and most regulated industries. Given their essential role supplying our daily water, power and waste management, and their naturally monopolistic nature, utilities are kept under careful watch by governments and regulators. This scrutiny benefits investors. A separate regulatory agency is usually the most effective at safeguarding ESG standards, particularly if the regulator is independent of the government and free from political interference. The UK has one of the most transparent and strictly regulated water sectors, arising from a well-developed legal system and autonomous regulator, Ofwat. In June 2018, it imposed fines of £120 million on Thames Water for leakages from its supply network. Environmental safety failures like this can lead to more than just financial penalties. Ultimately, the failure to protect consumers and the environment can lead to deteriorating credit quality and ratings, as well as higher funding costs.

Mining: Glass half full

The mining sector often gets a bad reputation when it comes to water. But miners, particularly multinationals, have some of the most rigorous and developed approaches to water efficiency. Managing water is essential, not only for day-to-day operations, but also because governments take it seriously, particularly where companies are in competition with local communities for a scarce resource. It's easy for a mine to contaminate the local water supply, which would be disastrous, so authorities cannot be seen to turn a blind eye. Investors know that clean-up costs are high and contamination can make them less willing to fund future projects and make new licenses harder to acquire.

For those reasons, before the first rock is turned over at a new pit, a good miner will have completed an extensive environmental evaluation and produced a comprehensive mine plan, including a detailed strategy on how to source and recycle water, and dispose of waste.

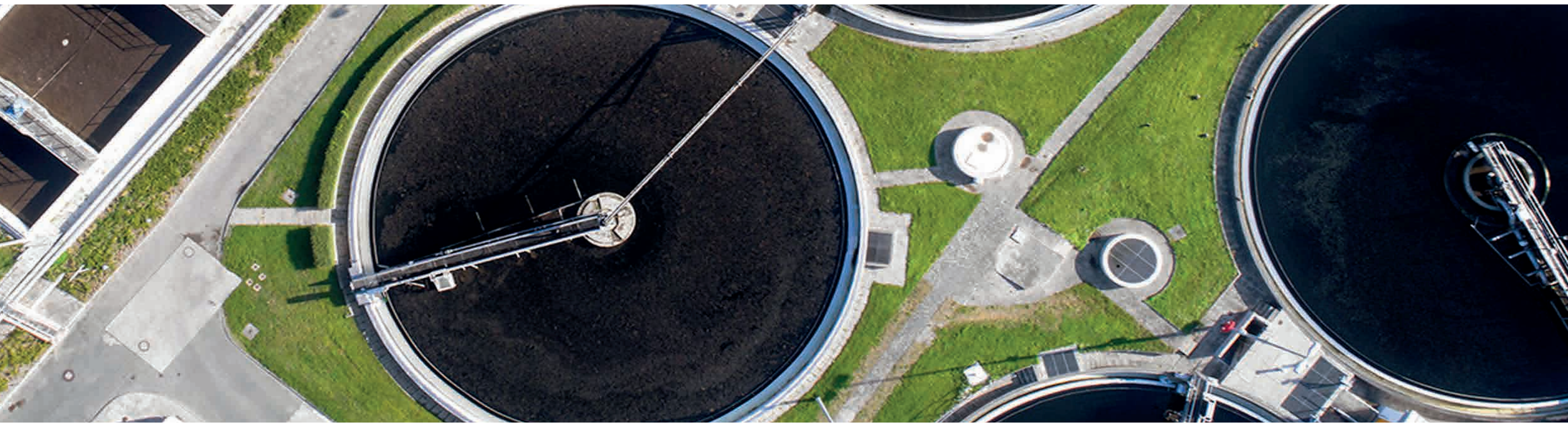
Yet, accidents happen. **Samarco**, the Brazilian iron ore joint venture by **BHP** and **Vale**, which failed in 2015 causing catastrophic flooding, killing 19 people and displacing several local communities.

Fidelity had invested in the bonds of Sarmaco and, in the aftermath of the accident, formed a bondholders group to negotiate with the company. Together with the government, we demanded a cleanup of the mess to be funded by BHP and Vale, and a return to normal, safe operations. This made sense from an ESG and business perspective.

Shipping: Murky waters

Shipping faces considerable upheaval from the adoption of new regulations. Whether the industry can pass on the cost of complying with the new regulations to customers will make a big difference to shipping companies' profit margins. For example, CMA CGM expects its annual fuel cost to rise by US$ 2 billion - a nearly 60% increase. Some estimates pitch the total cost to the industry of around US$ 240 billion by 2020 which is certain to reshape the industry. Understanding these scenarios can be time consuming and difficult. But lessons from other industries can support the analysis, for example, from those that have long faced curbs on emissions, or from utilities where scrubbers have been widely adopted. Moreover, some of these industries may be susceptible to knock-on effects. We expect clean fuel refiners to be winners from increased demand, and logistics companies to be losers from higher shipping costs.

What the example of water shows is that there is no 'one-size-fits-all' approach to assess ESG subjects. Using third-party ratings agencies is a good start but it will only get you so far - the heavy lifting happens with detailed analysis of each case. This deep diving can create enduring advantages for investors willing to do the work, and it sets up the conditions to engage productively with managements.



Sources: Fidelity International, January 21th, 2019. #ESG ; #Water ; #Waste