

## Water: The Next Big Commodity Wave?

November 2012

### Though demand for this natural resource is growing, water remains an under-invested corner of the market, says Jens Peers of Calvert Investments

Traditionally, water has not been a big focus for investors. At cocktail parties and on financial-news shows, resources such as gold and oil have more often been the topic of conversation. But that could change soon, argues Jens Peers, lead portfolio manager of Calvert Investments' Global Alternative Energy and Global Water funds.

Population and industrial growth around the world are driving up demand for water, even as supply remains relatively fixed, says Peers. He explains that this imbalance, combined with regulations to protect the water supply, is leading to an explosion in new technologies—especially among small and mid-size companies. Over time, Peers says, those firms could grow even larger to meet the needs in the U.S., and demand abroad. He recently spoke with Morgan Stanley's Tara Kalwarski about investing in water. What follows is an edited version of their conversation.\*

**Tara Kalwarski:** What's the case for investing in water-related companies?

**Jens Peers:** It's the only commodity we have that has no substitute. It's also the only commodity we can't live without.

From an investment point of view, we see a few important drivers. One is a simple supply-demand story. Demand for water is increasing at twice the rate of population growth. Some of that is due to birth rates, but some is also due to industrial growth and [rising] standards of living.

So demand will continue to go up, but supply unfortunately is fixed. Less than 1% of all the water in the world can be used as drinking water. [And] of that, two-thirds is captured in glaciers

and icecaps. We can't touch that. A study by McKinsey [ & Company] found that demand will increase by 2% per year through 2030. Unless something changes, there will be a 40% supply-demand gap. It's an unsustainable situation. So supply-demand dynamics are really positive in this space.

The second driver is a massive need for investment and infrastructure. A report by Booz Allen Hamilton, [like McKinsey, a consulting firm], found that from 2005 to 2030, an estimated \$22 trillion or so will be invested in water, which is about half of what's spent on infrastructure in general. Investment is needed because there is a lack of basic water infrastructure in emerging markets like China and India. In the industrialized [countries], there's been a historic underinvestment in infrastructure, and the quality of the underground pipes is appalling. At the moment, about six billion gallons of water are leaked per day in the U.S. That's about 14% of the daily water usage. At the same time, people are moving from the Northeast, which is a bit wetter [than other U.S. areas], to the Southwest, the dryer region. So we need to invest in new infrastructure, not just upgrade existing pipes.

The third important driver is increasing regulation. Regulators worldwide have supported price increases for drinking water because they want people to conserve. Price increases would also encourage private utilities to invest in infrastructure. Then there's quality: More and more contaminants are working their way into drinking water. That creates opportunities for new technologies like ultraviolet light, which treats infections. Regulation is also changing for wastewater. You can't just discharge wastewater and let it float back to nature. This goes broader, too. Water that's used for fracking [a process of

extracting natural gas from shale rock] needs to be treated before it can return back to nature. And all that is leading to significant opportunities for new and existing technologies.

**Kalwarski:** Are these themes dependent upon strong economic growth?

**Peers:** The impact [of a weak economy] should be less [severe when it comes to water-related investments] than [it is for] other industrial sectors—because everything starts and ends with water. If you want to live, you need water. Industries also need water to operate. There is a massive need for investment in basic water infrastructure, and that is independent from economic activity.

**Kalwarski:** Which industries stand to benefit from this trend?

**Peers:** To benefit from the drivers [described earlier], you want exposure to what we call the water cycle: pumping out the water, filtering it, delivering it, collecting wastewater, treating it again and returning it back to nature. And within that water cycle, we've identified three big categories for investment: water utilities, water infrastructure—pipes, valves, pumps and engineering—and water technologies. Filtration techniques, desalination, disinfection and metering, among other things, would fall under technology.

In all, we've identified about 140 companies that are investable, and about two-thirds of those are considered pure plays because more than 50% of their revenues come from water-[related] activities.

**Kalwarski:** How has that number changed over the last decade, and how do the companies vary geographically?

**Peers:** On the first question: The universe has probably increased by about 20% over the past five years. That's [because of] companies that have become a bit bigger and more investable, spin-offs, initial public offerings and companies that have become pure plays.

Geographically, the companies are located across the world. About 15% of the investable opportunities are in emerging markets and between 40% and 50% are U.S. names. Another 5% to 10% are Japanese names. The majority of what's left would be European.

From a revenue point of view it's about 30% North America, just over 20% Asia, 20% Europe and 10% Japan. To include a few other areas, the U.K. is about 8%, the Middle East about 5% and Latin America about 5%.

**Kalwarski:** Do you expect emerging markets to make up a bigger portion of those revenues going forward?

**Peers:** Yes, you have companies there that are coming to the markets. But remember what drives water demand: population growth, industrial growth and increasing standards of living. Those three drivers are growing the fastest in emerging markets.

But it's not just an emerging-markets story. Because of upgrade needs in the U.S., and because of new regulations for the quality of drinking water, Western companies are developing good technologies. They can sell that knowledge and expertise in emerging markets.

**Kalwarski:** Given the growing number of investment choices in water today, which industries within this theme appeal to you the most?

**Peers:** There are a lot of energy projects here in the U.S. and in Europe linked to the shift from coal-fired power plants to gas-fired power plants. And you need cooling towers, fire-fighting systems, pumps for processed water and pumps for wastewater. And the lead time for all of these projects—from the design phase to the plant opening—is typically between five and 10 years. So you have very, very high visibility. Also, it usually occurs later in the recovery.

There are a few niche technologies that [could potentially] benefit from new regulations. I think one of the most exciting opportunities has to do with [the discharge of] ballast water, the water that's been pumped into a ship to keep the vessel balanced. A ship pumps water in from a foreign harbor and dumps the water at the destination. In that pumping, however, the ship has probably taken on living species. These species are mixing with local organisms in the water and since they have virtually no natural enemies they can take over a habitat. From an environmental point of view, that's a very, very big issue. So eventually, per new regulations, every vessel that comes to the U.S. has to treat ballast water so that these organisms don't reproduce when they're discharged. There's movement to implement the same rule across the world. That [water-treatment] market is currently about \$200 million, and it will grow by about \$5 billion annually by 2015. The rate of growth will slow by 2017, as vessels get updated, but it's still a market that wasn't there before.

**Kalwarski:** Are there any companies or industries within this sector that are overvalued at the moment?

**Peers:** Currently, we think regulated utilities are fairly or marginally overvalued. That's an area we're quite cautious about. There's nothing wrong with these companies fundamentally. But valuation-wise, we'd be a bit more skeptical.

**Kalwarski:** What are the biggest challenges you face in managing this strategy?

**Peers:** It is an under-invested area, which leads to inefficiencies in the market. Not everything is always rational, and that creates both opportunities and challenges. There are a few companies that we think are incredibly cheap, but they've been like that for a long, long time. So I suppose it's just a matter of time for the market to see that the earnings growth is real. Dealing with that can be challenging. Also, liquidity: It's a very small space. Just buying and selling blocks of stocks at the right time can prove to be challenging.

But I'm pretty sure in 10 years the case for investing in water will be exactly the same thing, more or less. There's going to be more and more awareness, which will help liquidity. But [today], there are a lot of small and mid-cap [businesses] in this space that are really exciting. [Over time] they will become larger, better known and better researched by the market. I think that's only a positive point because it should support valuation even further.

*\*Unless otherwise noted, the source for all information in Jens Peers as of Oct. 22.*

The views and opinions expressed herein do not necessarily reflect those of Morgan Stanley. The information and figures contained herein has been obtained from sources outside of Morgan Stanley and Morgan Stanley makes no representations or guarantees as to the accuracy or completeness of information or data from sources outside of Morgan Stanley. Morgan Stanley is not responsible for the information, data contained in this document. Neither the information provided nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

The material has been prepared for informational or illustrative purposes only and is not an offer or recommendation to buy, hold or sell or a solicitation of any offer to buy or sell any security, sector or other financial instrument, or to participate in any trading strategy. It has been prepared without regard to the individual financial circumstances and objectives of individual investors. Any securities discussed in this report may not be suitable for all investors. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives. There is no guarantee that the security transactions or holdings discussed will be profitable.

This material is not a product of Morgan Stanley & Co. LLC or CitiGroup Global Markets Inc.'s Research Departments or a research report, but it may refer to material from a research analyst or a research report. The material may also refer to the opinions of independent third party sources who are neither employees nor affiliated with Morgan Stanley. Opinions expressed by a third party source are solely his/her own and do not necessarily reflect those of Morgan Stanley. Furthermore, this material contains forward-looking statements and there can be no guarantee that they will come to pass. They are current as of the date of content and are subject to change without notice.

Indices are unmanaged and not available for direct investment.

Any historical data discussed represents past performance and does not guarantee comparable future results.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment. Companies paying dividends can reduce or cut payouts at any time.

Investing in smaller companies involves greater risks not associated with investing in more established companies, such as business risk, significant stock price fluctuations and illiquidity.

International investing involves certain risks, such as currency fluctuations, economic instability and political developments.

Because of their narrow focus, sector investments tend to be more volatile than investments that diversify across many sectors and companies.

Diversification and asset allocation do not assure a profit or protect against loss in declining financial markets.

Investing in commodities entails significant risks. . Commodity prices may be affected by a variety of factors at any time, including but not limited to, (i) changes in supply and demand relationships, (ii) governmental programs and policies, (iii) national and international political and economic events, war and terrorist events, (iv) changes in interest and exchange rates, (v) trading activities in commodities and related contracts, (vi) pestilence, technological change and weather, and (vii) the price volatility of a commodity. In addition, the commodities markets are subject to temporary distortions or other disruptions due to various factors, including lack of liquidity, participation of speculators and government intervention.

***Investors should carefully consider the investment objectives and risks as well as charges and expenses of a mutual fund before investing. To obtain a prospectus, contact your Financial Advisor or visit the fund company's website. The prospectus contains this and other information about the mutual fund. Read the prospectus carefully before investing.***

Tracking No. 2012-PS-1413 11/2012

© 2012 Morgan Stanley Smith Barney LLC. Member SIPC