On the heels of an early 2016 trip to visit western multi-nationals in China to assess the state of the industrial economy, KBIGI’s water analyst Martin Conroy went to visit China’s domestic operators to size up the large and growing municipal and consumer water opportunities. The trip provided perspective as we strike the balance between capitalizing on the huge potential while trying to mitigate the risks.

Equity investors are rightly concerned about the impact of slower Chinese economic growth on company earnings, both in China and internationally. Here at KBIGI, one of our more frequent debates involves weighing up the risks of Chinese exposure against the undoubted potential opportunities that exist in the Chinese water market. Gaining further insight into these opportunities and subsequently balancing them with the risks involved formed the basis of my recent two week trip to China and Hong Kong.

In April 2015 the State Council of the PRC announced the 13th Action Plan for Water Pollution Prevention and Control. The plan which runs from 2016-2020 sets specific targets for the reduction and prevention of water pollution and improvements in drinking water quality. The estimated investment associated with the plan is US$700bn, which is more than double the amount that will be spent in Europe and the US combined over the same period. These numbers are significant by any standards but the challenge for investors is to balance the risk vs. reward of the opportunities that exist for each company. Getting an up-to-date overview of the Chinese water market by visiting the companies on the ground in China assisted greatly in the process.

The most common route to investment in the Chinese water market is through exposure to the domestic wastewater treatment and water supply companies. The authorities in China are actively pushing private investment in the municipal water market and as a result former state-owned enterprises (SOEs) now find themselves with private investors on board. In addition to these SOEs we have seen the emergence of numerous new companies in the water utility space in China, attracted by the opportunities in the market as a result of government policy. Combined, these companies provide ample opportunity for investors to get access to the Chinese market while at the same time they provide the capital required in order for local government to meet their specified targets under the five year plan. Many of these companies are targeting annual earnings growth rates of 20-30% over the next three years. These targets are based on the number of green field wastewater treatment facilities and upgrades to existing wastewater treatment facilities that will be required under the plan. There will also be a requirement for specialised industrial wastewater treatment providers, a market with relatively few players.
I met with five wastewater companies on my trip and visited a total of ten water treatment plants including municipal wastewater, industrial wastewater, and desalination and water supply facilities in Beijing, Tianjin, Shanghai, Guangdong and Hong Kong. The targeted growth rates are undoubtedly real and happening. Management teams are aggressive in their actions and strategic in their thinking. They realise that, slowing economy or not, water quality improvements are now a government priority. Management are positioning companies to benefit from the required investment in improved water quality in the years ahead. My access to companies on the trip included not just senior management which is obviously important, but also operations management and quality control teams at facilities. These are the personnel that can provide anecdotal evidence that they are seeing water treatment volumes increase, enforcement of regulation improving and new customers that had not previously treated wastewater coming online. As economies of scale kick in, the beneficiaries of this investment are in the early years of a multi-year growth cycle.

The other key take-away from the trip is the emergence of a new consumer-driven water market in China, further evidence of a gradual shift from an industrial economy to a more consumer-oriented one. The Chinese consumer is now more informed about the issues with water quality in the country and in a position to make better decisions about water consumption. Point-of-use residential water treatment is becoming big business in China and it creates a significant opportunity for some of the water technology companies we follow. These global multi-national companies produce modern counter-top water treatment systems that give consumers the confidence to drink tap water supplied by their local municipality. Our companies believe these products will become a standard kitchen appliance in China in the years ahead. They don’t come cheap with a mid-range unit costing in the region of US$600. In a country with a population in excess of 1.3bn there is room in the market for numerous large players, both domestic and international. The key issue for consumers is trust in the product and the Western brands have become somewhat of a status symbol, with the appliance getting a prominent position in the family home. The products have been customised by these technology companies for the Chinese market and as Western brands they command a price premium. We currently have holdings in the leading players in this under-penetrated market, a market I am even more excited about post the visit.
the third but less direct opportunity in the Chinese water market comes through water infrastructure companies. The investment in new facilities and the upgrade of existing facilities will see these companies benefit through increased demand for pipes, pumps, valves etc. Again these companies appear to be in the early stages of a multi-year growth cycle and my time with these companies saw them showcase the presence they have built up in China in recent years in order to maximise the potential of the market. These multi-national companies were only too happy to talk about the changes they have seen in the last year and the uptick in demand from their municipal water customers.

Despite the catalysts that exist for companies with exposure to the Chinese water market, there are significant risks, beyond the ever-present governance risks that are quite material in China, and which we monitor carefully. The slowing growth of Chinese industry is likely to result in slower growth of industrial wastewater volumes in some sectors. The challenge in analysing industrial wastewater treatment providers is to balance the impact of a slowing economy with the impact of increased regulation and enforcement. It is not long ago that it was cheaper for an industrial company in China to pay the penalties associated with violating regulations, rather than paying for the treatment of industrial wastewater. Likewise a slowing economy could ultimately impact consumer spending and potentially some of the water technology companies. The risk/reward balance here needs to take account of the impact of potential reduced consumer spending on our companies versus the desire for households to ensure safe drinking water for their families. Finally our infrastructure companies are faced with the risks associated with the more cyclical nature of some of their end markets. As well as playing into the municipal water market they also have significant exposure to water-related activities in construction and industrial end markets, markets that are later in the cycle than the municipal water market.

I returned fully appreciating the growth potential in the Chinese market. This growth will be driven by government policy and increased consumer awareness and spending, but it clearly doesn't come without risk. Some of the risks are macro related while there are also risks at the company level. Rigorous analysis combined with constructing a diversified portfolio remains the key and this is what our investment process and portfolio managers aim to deliver.

- Martin Conroy, Water Investment Analyst
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