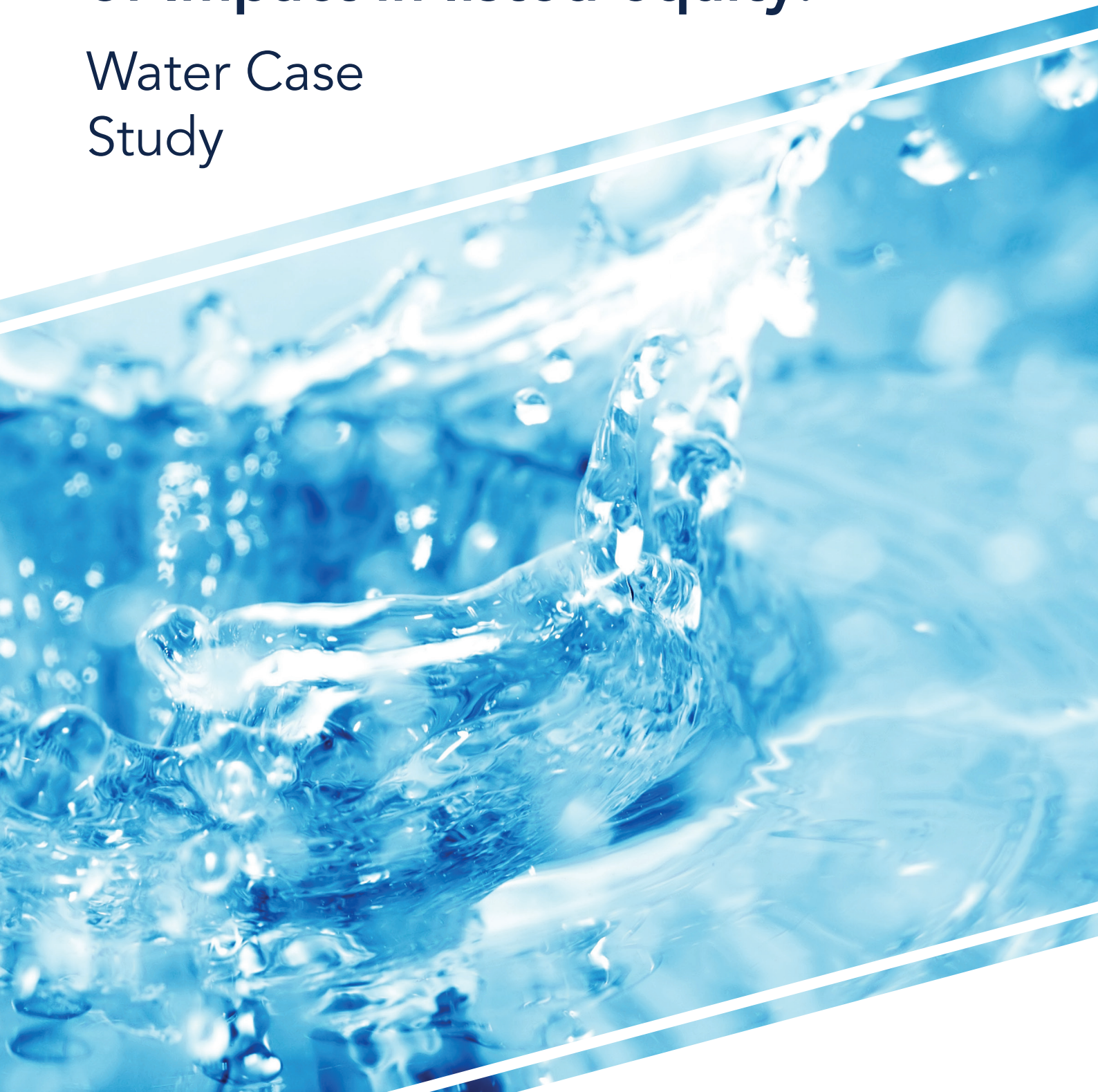
KBIGI

KBI Global Investors

AP7

Improving measurement of Impact in listed equity:

Water Case Study



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FOREWORD FROM AP7

Impact investments are defined by the fact that they not only provide financial returns but also create environmental and societal benefits. The financial return is easy to measure in the sense that there are lots of different measures and methods that are well known and established. That is not the case when it comes to the investments' benefit for society. It is difficult to measure, and authoritative standards are lacking.

When we started the collaboration with KBIGI in 2018, we agreed to jointly try to contribute to the development of methods and metrics. With that ambition, it is a great advantage that the operations of the companies concerned are not too diverse. In this case, they are united by a link to SDG 6, clean water and sanitation for all.

After three years of work, it is time to summarize the lessons so far. One conclusion is that there is a lot to do for anyone who wants to play their part. Better data is constantly in demand in all forms of sustainable investments and active engagement is an opportunity to add value to pure investments. Many of the companies can be developed with the right support from the owners, including when it comes to reporting.

Another conclusion is that there is a long way to go before we even begin to approach any form of standardized measurement methods. Complexity is a challenge when comparing different companies with different products in different places, even when only one SDG is in focus. Quantifying the benefits is also a challenge, especially if the ambition is to sum up positive and negative impacts.

Today, there are many different initiatives in different parts of society that look for solutions and drive the development of evaluation methods for the societal benefits of investments. It inspires hope. We are happy that we, together with KBIGI, have been able to be part of that process.

Johan Florén, Head of Communication and ESG, AP7

Flora Gaber, Manager ESG Analysis, AP7

KEY FINDINGS: Identifying net positive impact

Investing in global water stocks that provide solutions to critical issues has an impact and serves to advance environmental and social goals.

Measuring impact is definitional and difficult, however. This is because:

- few companies report on their impact
- the availability of information varies significantly with no two companies measuring impact in the same way
- there are a multitude of avenues of impact

Having engaged with management teams in the water space, **we're encouraged to see more companies striving to provide better information for investors.** They appreciate the importance of increased transparency and are making impact a strategic priority. This has no doubt been driven up their agendas by the evolution of reporting regulations and the highly anticipated European Taxonomy coming down the line.

That said, we acknowledge our role as active investors in driving this evolution. While it is difficult to claim that investing in listed water companies has additionality* in the purest sense - investors in public companies are not in control of strategic planning, capital budgeting, and resource allocations - we argue **a broader definition must include active ownership of companies that clearly advance societal goals and target positive impact through their activities.**

Our work shows that impact can be assessed in both quantified and subjective ways, with a holistic approach making the most sense. While many impact measurements to date are mainly focused on the positive effect of a company's goods or services, our approach looks to balance that with any related negative effect.

Our intimate knowledge of the companies we invest in, born of our active long-term ownership and frequent interaction with management teams, enables us to access and understand a level of granular information that otherwise would not be available.

As our case studies show, we have been able to establish company-specific impact assessments through our deep engagement with management teams. These assessments serve as a basis for ongoing dialogue. They are also tangible and can be monitored and, most importantly, they show these listed companies are having a net positive environmental and social impact.

Key Findings

Investing in global water stocks providing solutions to critical issues has an impact and serves to advance environmental and social goals.

We are encouraged to see more and more companies prioritising impact in a strategic sense.

Our approach looks to balance the positive effect of the solutions that the company provides, with any negative effect in achieving those outcomes.

An intimate knowledge of the companies we are investing in allows a level of granularity that otherwise would not be available.

We have been able to establish company-specific impact assessments. These serve as a basis for ongoing dialogue but most importantly they demonstrate that these listed companies are having a net positive impact.

* additionality as it relates to impact investing means producing a beneficial environmental or social outcome that would not occur but for the investment in the underlying company.

EXECUTIVE SUMMARY

KBI Global Investors is an active manager in the listed global equity space, taking a 'solutions provider' approach to investing in water.

When we first devised the Water strategy in 2000, we identified five indisputable drivers in this area:

- finite supply
- increasing demand
- increasing regulations
- the need for investment in infrastructure
- the need for investment in technology

The water infrastructure, utility and technology companies in which we invest offer a broad range of solutions addressing these critical issues. We have long been able to point to positive examples where our companies are advancing environmental and social goals and, as a consequence, are having a meaningful real-world impact on their surroundings and end consumers.

Moving towards tangible measurement

Our assessment of this impact has evolved meaningfully over recent years. Through regular engagement and active ownership of our investments in the water space, we have moved beyond ad hoc impact anecdotes to build out a more tangible and quantifiable way to assess if our companies make a difference. This includes alignment with the United Nations Sustainable Development Goals (SDGs).

We produced our first assessment of the impact of the Water portfolio in 2018, with our RASS (Revenue Aligned SDG Score) project. This involved aligning the revenues of our portfolio companies to the UN Sustainable Development Goals, which enabled us to estimate the portfolio's impact.

A valuable collaboration

Through our collaboration with AP7, we have been able to build further on our expertise, tweaking our approach by focusing on four of the 17 SDGs, as specified by AP7. Furthermore, we broadened our analysis to take a more holistic view of the companies as opposed to focusing on their business activities only. We now look at both the company's footprint (how it conducts itself as an organisation) as well as its handprint (its products and service offering to the end user).

In this report, we outline how we came to develop an impact scoring methodology with AP7. During this process, we:

- took into account positive impact considerations
- established adverse impact indicators at company level
- went a step further, seeking to differentiate between companies as to their level of impact.

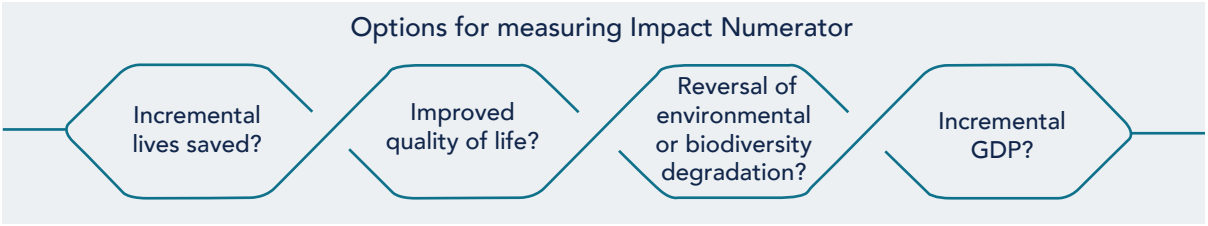
The case studies in the report show how we engaged actively with companies, targeting specific information gaps, while also outlining why and how we succeeded in driving better transparency of impact information. This has ultimately served to make for a more robust impact scoring system for companies, which can be used to form the basis of future monitoring and engagement.

1. INTRODUCTION: Looking to the SDGs

Measuring impact in its truest form is exceptionally difficult. A company improving water quality clearly generates a beneficial environmental and/or social impact. But what is the unit of measurement for impact?

Could it be:

- Incremental lives saved?
- Improved quality of life?
- A reversal of environmental or biodiversity degradation?
- A second order effect like incremental GDP?



And who gets the credit? Should it go to the company making the water treatment technology or the water utility using it?

These results seem nearly impossible to calculate and directly tie in to the underlying activity, making this a job for PhD sociologists and peer-reviewed research journals, rather than investors.

For an investor in the company trying to assess their own impact by virtue of their involvement, how can they understand real impact, for example, lives saved per what? Per dollar invested? Per dollar of revenues or capital spending at the company?

Shining a light on additionality

This touches on the concept of additionality, which itself is fraught with definitional complexity. If an investor buys a share from another investor, they're swapping ownership of a stake in the company. That doesn't advance anything regardless of the company's level of impact. The impact would have happened anyway.

Participating in a capital raise could be deemed additional, but that is not necessarily the case - the money could be used to pay off other owners or pay down debt or could be allocated to non-impactful activities.

The clearest additionality from investors would seem to come from angel investing to get a business off the ground or specific project financing, in which the capital connects directly to the activity generating the impact. Even then, if the angel investor or project financier did not invest but some other investor did, should their investment be considered additional? As with the previous example involving shareholders, the impact would have happened anyway.

To draw the straightest line between investor involvement and additional impact, one would have to be the financier of last resort, the only one willing to invest and do you really want to be that person? Even if you do, it's hard to argue that investing at this level leads to impact at scale.

Additionality is about more than incremental capital, of course. It is also about setting forth initiatives and directing resources, capital or human, to carry out the mission. In this sense, investors can play a role to varying degrees, if their involvement facilitates incremental impactful activities. This can happen at scale.

The state of impact reporting

Ever heard someone say: "*Investors don't generate alpha, management teams do*"? It's definitely one to provoke a lively conversation, and there are certainly interesting parallels between alpha generation and additionality, and the role of investors in actively identifying and influencing impact.

For a company, it is increasingly straightforward to measure its footprint or the impact of how it provides customers with goods and services. That's due to standardised metrics and disclosure platforms around energy, waste, carbon emissions, and water. On the other hand, it's far from easy to measure its handprint measurement, or the impact of what it does, although some companies are trying to report on this impact. That's a welcome trend, and investors and stakeholders should encourage it.

In reality, however, proactive companies are not reporting impact. They generally report outputs (for example, how they treated 100 billion litres in a year) or, less often, on outcomes (for example, how they saved 1 billion gallons of water waste).

Moreover, those companies that attempt to report find it almost impossible to compare their results with those of other firms. Other than straightforward customer counts or litres treated, it is rare to find any two companies measuring outputs or outcomes in the same way.

A version of impact reporting we have seen grow materially in the past two to three years is companies identifying which SDGs their businesses support, in a non-quantified way (for example. segment X supports SDGs 3, 5, 8, 9, and 12), but this is difficult to roll up at a portfolio level for reporting purposes.

A move to better impact reporting

It is in this complex context that we began our journey to report on our portfolio's impact, before our collaboration with AP7. In the past, our clients occasionally asked us if we measured our portfolio impact. We would offer a handful of anecdotes about what our companies were doing as solutions providers to global water challenges. Unsatisfying as that was, clients tended to accept that response.

In our search for a better way to measure impact, it was clear there was no single mutually agreed established methodology. But we decided that reporting impact is much too important to wait years for an agreed industry methodology and databank to emerge. If we could devise a useful methodology (while recognising it may not be perfect and may evolve over time), we knew we could make a valuable contribution to the cause of responsible investing.

Addressing an array of issues

No single metric could cover the variety of problems our companies were trying to solve. These include:

- hunger (irrigation)
- health issues (sanitation)
- access and affordability (utilities)
- liveability of cities (stormwater management)

Many companies are trying to address a combination of problems and may even have business lines that work against environmental goals, such as equipment sold into the oil industry.

Aggregating or averaging out these effects at a company seemed like an over-simplification when it came to deciding if the company as a whole was making an impact. Instead, we opted in 2017 to examine each business activity of each company in our portfolio. We came to see that the various avenues of impact across our companies aligned with the 17 recently adopted UN SDGs.

This was the Moneyball* moment. By aligning with the SDGs, we could distil our impact reporting to one metric instead of a multitude of disjointed anecdotes: **the percentage of the portfolio's revenues aligned with the achievement of SDG targets**.

All we needed was a breakdown of all revenues by business activity at each company and an assessment of whether those activities help to achieve the targets or are detrimental to them. No third party offered this activity breakdown and impact assessment, so we pushed ahead and did it ourselves. Who better to analyse this granular level of detail than specialist investors with a long track record in the industry and an intimate knowledge of our companies' activities?

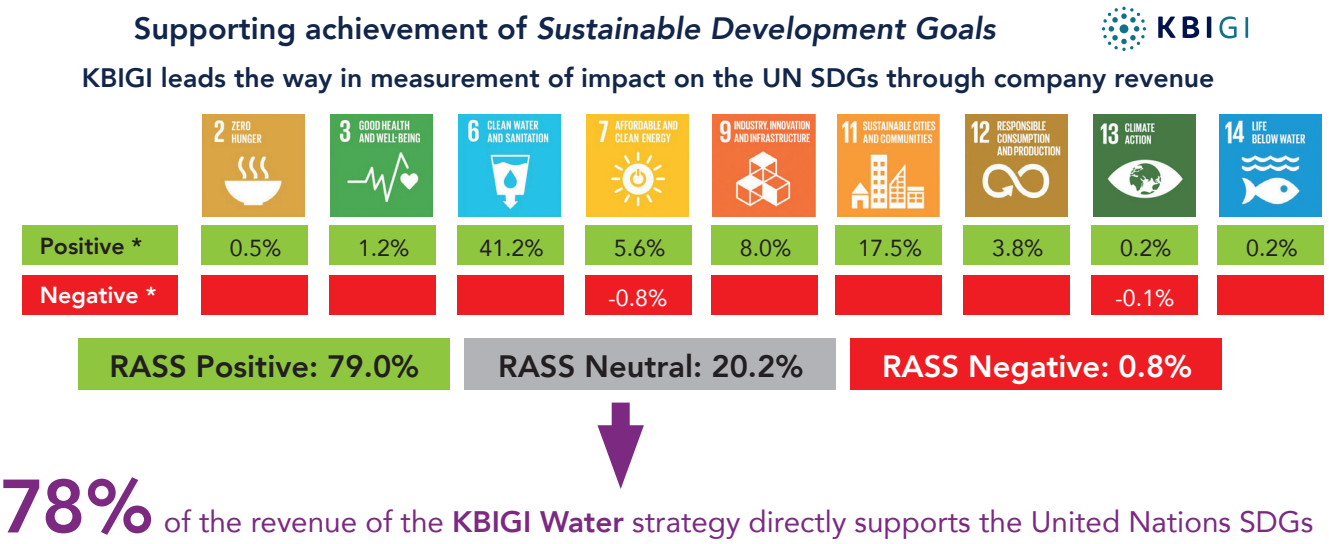
*Moneyball refers to a book by Michael Lewis documenting a baseball team's analytical work to find metrics that identify undervalued players. The team was able to distil enormous quantities of player performance data to two statistics that successfully helped build a winning team on a low budget ie. on-base percentage and slugging percentage.

A revenue-aligned SDG score

As a result, we developed the RASS, the Revenue Aligned SDG Score, as a single metric for reporting on impact. It's a helpful and intuitive metric that aids understanding the impact of the portfolio. But it has flaws. First, it defines 'impact' in a convenient way. It doesn't quantify improvement in lives or the environment and it doesn't differentiate between degrees of impact. It merely ties a business activity to aligning with the targets underlying the SDGs.

That leaves us with questions, however. Is USD1m of revenue from a utility serving a developed world populace as impactful as USD1m generated in a developing country, where access to clean water may be limited and the uplift to quality of life more material?

Furthermore, the RASS is a metric reported as a percentage and does not have a denominator, only because it uses "per owned revenue" in the numerator too (and they cancel each other out). Owned revenue references the percentage of the company an investor owns times the revenue (per activity). From an additionality perspective, it assumes the activity would not happen without the business owner, which is unlikely to be true. As active owners in dialogue over time with our companies, mostly small and medium (SMID) cap companies, we believe we do have some influence.



Drawing on deep business expertise

The first part of the analysis - determining the revenue for each business activity of each company in the portfolio - was a significant piece of work. We had to identify close to 100 different business activities and the revenues accruing to each. While that was relatively straightforward for a few companies with only one business line, most had many different business activities.

Moreover, a company's products and services may serve different end markets. The same dewatering pump, for example, could be used in municipal bypass work (positive) or for pumping water to oil and gas drilling sites (negative). We needed to differentiate at this level.

This complexity means only our portfolio management team could conduct the detailed analysis needed, as they had the deep expertise to do it. For each of the almost 100 different types of activity, they sought to determine if it was:

- helping to achieve the SDGs
- neutral to achieving the SDGs
- detrimental to their achievement

When they identified a positive or negative impact, they then had to allocate it to a particular SDG.

Rather than have an anecdotal sense that investments in the Water strategy were contributing favourably to achieving the SDGs, we have been able to quantify this in a transparent, albeit imperfect, methodology. Unsurprisingly, the percentage of revenues aligning with the SDGs is high for our water strategy.

A company improving water quality clearly generates a beneficial environmental and/or social impact.

2. DEVELOPING THE IMPACT SCORING METHODOLOGY

AP7 appointed us to manage a Green Impact Equity mandate in 2018. The mandate objective was twofold:

1. **generate alpha by investing in a portfolio of water stocks with returns exceeding the benchmark**
2. **help attain a Green Impact objective by working collaboratively with AP7 to enhance an impact measurement methodology for listed equities.**

To achieve the second goal, we set up a project with input from AP7, with the main deliverables being the implementation of a pilot methodology for measuring enhanced impact and a report outlining our findings and issues we encountered during the process.

We began with information exchange workshops so that AP7 could develop a deep understanding of our RASS impact measurement methodology and so we could agree the exact Green Impact deliverables AP7 needed. AP7 then introduced us to the research undertaken by Professor Johan Rockström of the Stockholm Resilience Centre, Stockholm University, which promotes the concept of a hierarchy across the UN Sustainable Development Goals.

Source: Azote for Stockholm Resilience Centre, Stockholm University

Building on this research, we agreed to focus on four specific SDGs that AP7 sees as the most important:

6 (clean water and sanitation)

13 (climate action)

14 (life below water)

15 (life on land)

Instead of focusing on a company's revenue-generating activities, as we did with RASS, we decided to go deeper and attempt a more holistic approach, looking at the impact of both a company's footprint (how it conducts itself as an organisation) and handprint (its products and service offering).

Step 1: Scoring methodology

As outlined in the previous section, our aim was to quantify not just the positive but also the negative impacts of each activity as it relates to the four prescribed SDGs. We also wanted to differentiate between companies in terms of their degree of impact, a shortcoming we already highlighted in the RASS methodology.

KBIGI and AP7 developed the impact scoring methodology collaboratively, developing a scale of -4 to +4, representing impact levels varying from very high to neutral to very low. Building out the scoring methodology to define those scores was a key part of this process and formed the basis for engagement with companies on specific areas as the project evolved.

Key considerations for high scores

If a company's solutions address the needs of **municipal or agricultural end markets**, we deem them more impactful than if they address the needs of industrial customers. It is more impactful to provide water transport and treatment equipment and technologies to a water utility that secures access and reliability of service to local communities, for example, than it is to provide pumps and valves to transport and control the flow of process water around an industrial production plant.

Equally, providing drip irrigation equipment, which allows for the more precise watering of food crops in water-strained regions and drives meaningful water efficiency savings, trumps treating water to an ultra-pure state to enable the production of semi-conductor chips for the electronics industry.

Companies that focus their solution set on **emerging market economies** were deemed more impactful than those focused either solely or mostly on developed markets. Water utilities in China and Brazil, for example, are investing capital predominantly to build out new connections to areas of the population that would not have access to clean water otherwise, and also treating water to acceptable standards for safe consumption.

We sought more **additionality, intentionality and commitment**. Knowing the company well and engaging with it frequently gives the best sense as to how to evaluate it in these areas. Providing people with water and sanitation services when they haven't had access previously is clearly additional and more impactful. Offering a solution to treat emerging contaminants in wastewater when there isn't a mainstream solution is additional.

We can also assess intentionality and commitment by understanding a company's strategic priorities and what drives their capital allocation decisions beyond financials:

- Do its product development and geographical expansion plans have sustainability and impact as key priorities?
- Is it holding itself accountable to measurable targets that can be monitored?

While our RASS methodology covers more than the four specified SDGs, **a high RASS** is useful as a good cross-check for a company's overall level of impact.

Having a solution set that advances **affordability, regulatory compliance or waste reduction** or improves access also contributes to a higher score for a company.

A brief synopsis of the scoring system

Understanding negative impact

As the next step in the scoring methodology, we considered negative impact and the adverse impact indicators for companies. This included:

- Negative biodiversity-related impact, such as deforestation and the disruption of ecosystems
- Association with oil and gas/energy end markets
- Carbon emissions
- Controversies or incidents surrounding products or company operations

When we couldn't get information on negative impact, our default score was zero. We also took the recency and the materiality of a negative impact exposure into account, such as the percentage of revenues exposed to oil and gas end markets.

Our sources for this information included:

- company annual reports
- publicly available communication with the market
- MSCI ESG research
- ISS (proxy voting service provider) reports
- company sustainability reports
- communication with management teams

Step 2: Applying it to the Water portfolio

We evaluated the 44 infrastructure, technology and utilities stocks in the KBI portfolio at the time on the basis outlined above.

We found:

- **Emerging market companies, specifically utilities, scored highest on impact**. That's not surprising given their key role in implementing environmental policies related to water, which drives impact and additionality in developing markets.
- **Engineering and consulting companies scored highly** on the basis of the comprehensive solutions set they offer to address water and climate change issues, resiliency and environmental compliance.
- **Technology firms** providing innovative solutions for improving energy efficiency, reducing the cost to serve and hence aiding affordability and enabling wastewater reuse scored highly.
- **Industrials scored low**, particularly more US-focused smaller caps. This wasn't helped by the lack of information from them, given they are earlier in their journey in terms of having systems in place to provide it.
- **Information on negative impact was harder to come by**, such as that relating to biodiversity, and environmental or product incidents.

3. THE NEED FOR ENHANCED ENGAGEMENT

By building these considerations into our impact score, we tried to be as all-encompassing as possible to capture all the ways a company can make an impact, evaluating not only more visible outputs like their solutions or geographic exposure, but also considering any negative implications of their activity.

We also built an assessment of internal company initiatives and culture into the score, enabling us to take a view on the sustainability of the impact and a company's momentum going forward. Knowing the company well and having an active dialogue with management was key to gathering this information. This is particularly true given the lack of availability of some data and the fact that some of these considerations are subjective rather than being easily quantifiable.

By breaking down the impact score, we could also differentiate between the levels of impact of different companies, thereby identifying best practices and allowing a hierarchy of sorts to evolve. We concluded that we needed enhanced engagement with some companies to fill in the information gaps and make the scoring system more robust.

Driving out the detail with enhanced engagement

In the next phase of the project, we focused on working towards an enhanced impact measurement relating to the same four SDGs (6, 13, 14 and 15). We focused in more granular detail on 10 portfolio holdings and the critical issues we see for each of them. We undertook enhanced engagement on specific details with each company so we could better ascertain the 'real-world' impact of operations, both positive and negative.

We chose the 10 companies to make up a diversified sample set representing utilities, infrastructure and technology, and being diverse across end markets and geographies. We also wanted a mix of companies that scored well on our first iteration but left us with questions around the sustainability of their positive impact. We were also conscious some companies had potential negative impact, or we had other information gaps, so we sought to delve deeper.

Our end goal was to enhance our impact scoring methodology for these companies, making it more robust and considered. We also hoped to develop company-specific impact indicators we could monitor over time. Furthermore, we wanted to overlay some quantification to support our hitherto more qualitative assessment.

We wrote to all 10 companies with specific questions for each of them. The following case studies highlight three of these to show what type of questions we asked and the quality of information we received.

The 10 companies we selected:

aalberts | COSTAIN | SPX | Stantec | China Water | orbia | United Utilities | Consolidated Water | San Jose Water | valmont

Impact investments are defined by the fact that they not only provide financial returns but also create environmental and societal benefits.

i - China Water Affairs: accessing a rich pool of information

中國水務集團有限公司
China Water Affairs Group Limited

China Water Affairs is a Chinese water utility that supplies raw water and tap water supply to industrial and municipal end users, and provides services such as sewage treatment, metering and connections. Its business model involves forming joint ventures with local governments to upgrade and expand existing water facilities using its expertise.

China Water Affairs' revenues align favourably with the UN SDGs, particularly SDG 6 (clean water and sanitation) with a 91% positive alignment. Taking our assessment beyond revenue alignment of activities, we applied our scoring methodology, awarding the company the highest mark, 4.

The basis of our scoring decision

This high score is justified. China Water Affairs' water supply operation and construction business has connected over 5.7m users across 30 provinces and 60 cities. It focuses in these locations on extending water supply to rural areas and improving access, by either extending pipelines or setting up small-scale centralised water supply projects.

Clearly, there is higher additionality attributable to China Water Affairs as an emerging market utility compared with a developed world counterpart as it is building out new connections where the need is greater. We wanted to acknowledge this in our score.

We can see the company's intentionality and commitment to impactful activities in its recent capital allocation decisions.

In early 2019, it acquired a 29.5% stake in Kangda Int'l, a leader in the environmental protection space, particularly focused on wastewater treatment and drainage.

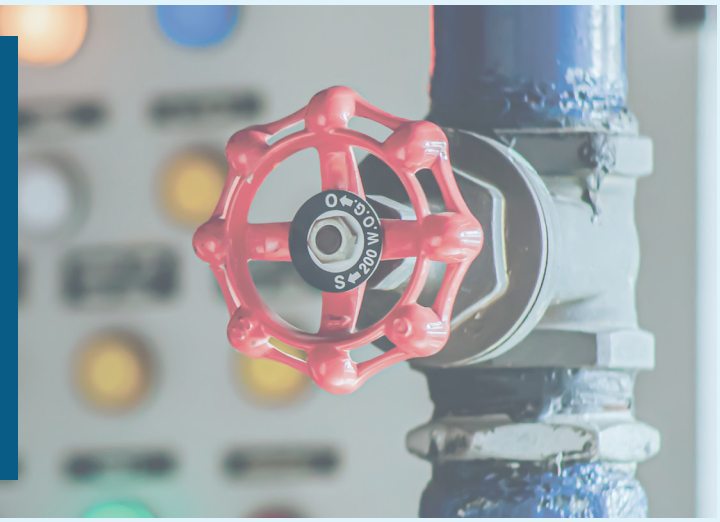
Over the past two years, it has entered joint venture arrangements with companies such as ORIX and Tora to advance their developments in direct drinking water offerings, such as at the point of use in the home. It is also enhancing water quality in its facilities in adherence to regulations.

Finally, the company's track record on reducing power consumption and leaks over recent years (14.3% leakage rate in 2020 vs industry average of 22%) is good and indicates it is prioritising these.

Why and how we sought more information

While it wasn't difficult to find positives in terms of impact, information on potential negative impact was not easy to find so we awarded the company a zero score on that front. Lack of information was not a satisfactory reason for this, which is why we tried to fill in the information gap.

Getting better quantification on potential negative impact and other key indicators was a priority as we compiled our questions for our enhanced engagement phase with China Water Affairs. Utilities and their operations are highly localised, so we had to consider that too.



We sought:

- **Information around sources of water supply**, some insights into the sustainability of these sources and the company's strategies to protect these resources.
- **A better understanding of its wastewater treatment business**, including the sources of this wastewater (which could be residential or industrial, for example), more information about its pollution levels at the input stage and data on the company's success in eliminating pollution during treatment.
- **Information on the overall impact of its operations on the surrounding environments.**
    - Has water quality improved in the regions where China Water Affairs operates because of their water treatment processes?
    - Have there been any environmental breaches over the past two years?
    - How does it monitor the biodiversity impacts of its business on local water resources?
    - Has it undertaken any studies to ascertain negative environmental impact?

Responses from the company

China Water Affairs gave detailed responses, with enough quantification and explanation. It told us all the resources it draws from (surface water from rivers and lakes) have gone through sustainability feasibility studies by independent third parties and then been granted a 'water extraction right' by the government under national water law.

Local government regulations then govern extraction with agreed pre-set quotas diversified across supply resources and water supply given priority. There are also backup plans in place for emergencies.

On the wastewater treatment side, the bulk of which is residential, the company shared details on the treatment technologies it uses along with compliance standards that govern water quality, which it both meets and monitors consistently. It also has plant-by-plant detail on emissions reduction, and manages leakage rates and energy savings at the site level.

Finally, responding to our concern on the biodiversity impacts of their business, it told us an environmental impact study is a prerequisite to getting government permission for a project to go ahead. The goal is not just minimised negative environmental impact on key elements such as soil, water and the local ecosystem, but to improve it where at all possible, for example, by planting trees around treatment plants. It confirmed there has been no environmental breach over the last two years.

Conclusion: the value of seeking more information

Our enhanced engagement with China Water Affairs reassured us about the sustainability of its water supply sources. We are also encouraged by its internal monitoring procedures for water quality before it leaves the plant and for plant emissions.

There is established regulation in place that helps drive the company's activities in these areas, and looks to minimise negative environmental impact. This regulatory oversight alone should safeguard against any controversies and incentivise the business to move towards being best in class. While there is a perception that emerging market regulation is not always as stringent as that in the developed world, there is a certain amount of 'taking the company's word for it' and we acknowledge this. That said, we have visited three of their facilities in the past and they all appear to be operated in an efficient and responsible manner, more on a par with developed world utility facilities. China Water Affairs has an excellent track record in transforming underperforming facilities and upgrading water quality standards. Furthermore, the Chinese government has well publicised and clear priorities on the environmental side and has been known to enforce penalties such as fines and even imprisonment for breaches in regulation.

Given how responsive China Water Affairs was and the high quality of information it gave us, we would like to build on this process and move towards better quantification of impact. Metrics we could target include the:

1. **Number of new connections**, with a view to monitoring connection/access growth
2. **Leakage rate across its system**, related targets and more information on how this is monitored and improved on over time
3. **Percentage of supply from different water sources** and further information on how the lowest levels reached in these sources is monitored.

These three metrics could form the basis of a set of standard indicators of impact we could apply across our utility holdings given their common business model. That would enable us to identify and compare leaders and outliers.

ii - Costain: proactive in making impact

Costain is an engineering, consulting and construction company that provides smart infrastructure solutions across the UK's energy, water, and transportation markets. The core technologies and services it offers are designed to reduce the impact of client activities on the environment.

Across its clients' infrastructure programmes, it helps to:

- safeguard security and resilience
- increase capacity
- improve customer service
- drive efficiency

Costain's revenues align favourably with the UN SDGs, with a 96% positive alignment. This is mainly across:

- SDG 6 (clean water and sanitation), through its water and wastewater construction activities
- SDG 9 (industry, innovation and infrastructure) through its engineering and consulting activities in industrial end markets
- SDG 11 (sustainable cities and communities) through its transport construction services

None of its revenue aligns with the SDGs specified by AP7 other than SDG 6 (23% of revenues). We bore this in mind as we scored the company for impact using our scoring methodology. While the company is increasingly focused on renewable energy end markets key to climate change policy, its contribution to SDG 13 (climate action) is not material at this point. We awarded the company a score of 2.

The basis of our scoring decision

Water is a key and growing end market for Costain and its activities here are clearly aligned with SDG 6. Its solutions enable clients, mainly water utilities, to:

- improve drinking water quality
- increase the standard of treated wastewater
- improve the efficiency and resilience of the water network by reducing leakages and ensuring less downtime.

It mainly does this by rehabilitating existing infrastructure and building new infrastructure. UK water utilities must meet strict environmental and customer service standards as set by the regulator (Ofwat) and Costain provides project management expertise to meet these goals, enhancing reliability and addressing regulations.

As Costain is predominantly focused on the UK, a developed market, where the water infrastructure assets are already of a high standard, its level of additionality is somewhat reduced.

In terms of Costain's operations, the company takes its environmental responsibilities seriously and has a robust strategy in place to reach net zero by 2035, 15 years ahead of the target set by the UK government. The company gathers a meaningful amount of data on carbon intensity and environmental incidents. It also includes targets in every contract to measure its biodiversity impact using a 'no net loss' calculation. Overall, its environmental strategy is robust and well above average, especially considering its size. This shows its intentionality and commitment.

Why and how we sought more information

Once again, we found information on negative impact difficult to come by, so we awarded a zero score there. As with the previous case study, this was a focus of our questioning at the enhanced engagement stage as was further quantification of positive impact.

We sought:

- **Information on the positive environmental impact of the water business** in areas where Costain has worked with utility companies. For example, the before and after improvement in water quality, leakage and water resiliency or any improvement in environmental data where it played an advisory role. We asked if there had been any environmental breaches over the past two years and if Costain monitors its biodiversity impact on local water resources.

- **More information about the environmental impact of Costain's transport business** as it relates to SDG 15 (life on land) given its high-profile contract with HS2, the high-speed rail project linking London, the Midlands, the North and Scotland. We also asked about any measures it took to mitigate negative biodiversity impact.

- **More about its role as an engineering and consulting company in developing policies related to SDG 13 (climate action)**, such as agencies it has worked with and recommendations it has made to develop progressive policies.

Responses from the company

Encouragingly, the responses from the company were very detailed, exceeding our expectations given its size (sub GBP200m market capitalisation). In offering design, engineering and consulting services to UK-regulated water utilities, Costain supports them in meeting their regulatory and customer obligations and minimising any negative impact on the environment, which tends to be heavily penalised by regulators.

Costain gave us a detailed list of its advisory work, which includes:

- improving water quality
- introducing flood management systems
- ensuring security of supply
- upgrading treatment works
- reservoir upgrades
- improving wastewater effluent quality

The Water Framework Directive sets water quality standards, while the Urban Waste-Water Treatment Directive sets those on effluent quality improvement. Costain also shared case studies showing how it works to optimise the performance of clients' existing infrastructure assets and operational systems, to increase existing capacity, improve resilience and minimise downtime while reducing operating costs.

When it comes to measuring and monitoring the biodiversity impact of its business on the water resources and land, the company has its own internationally certified environmental management system (ISO 14001) and a group environmental policy statement. This system includes procedures to control Costain's impact on biodiversity, to minimise and measure that impact, and to offset negative impact by enhancing habitats, for example.

Each of its projects aims to achieve a net positive biodiversity impact and to increase natural capital value.

In 2020, it introduced a policy stipulating that each of its transport-related contracts must measure biodiversity and natural capital impact, and work with clients to make a net gain.

Furthermore, a digital team developed a geographic information system (GIS) tool to enable project managers to assess biodiversity and natural capital impact quickly, and to model the finished solution.

A good example is the HS2 project, for which the team carried out 755 ecology surveys in the initial stages as it sought to assess biodiversity impact. To mitigate and balance the impact of the scheme and help meet HS2's 'no net loss' target, the company created and enhanced great crested newt ponds, installed 15 bat boxes and six barn owl boxes, and implemented 'no dig' zones close to important plantations.

Big-picture thinking on climate and energy

Costain launched its own climate change action plan in 2019. It outlines a 15-year programme to transition to net zero by 2035, by eliminating direct emissions, but also by addressing scope 3 emissions from client and supply chain footprints. Its goal is to collaborate with clients and supply chain partners on this front, with the support of government and industry bodies.

It also looks to challenge industry norms by providing proactive solutions to customers, for example, by encouraging the transition to and use of energy-efficient technology, and enhancing existing infrastructure through technology management systems.

It pointed to UK water utility Severn Trent, which needed to upgrade its wastewater treatment facilities to meet new enhanced effluent treatment standards. The original plan was to increase the operating footprint of one of the facilities by 33%, meaning significant capital expenditure on the new building and aeration systems, and significantly more emissions. Costain got involved at the design phase and proposed an alternative solution.

Rather than Severn Trent extending and building a new asset, Costain recommended it install Integrated Fix-film Activated Sludge (IFAS) technology within the existing asset and retrofitting an innovative tertiary solids removal process into the existing sand filter.

Recognised as the Wastewater Innovation Project of the Year at the 2020 Water Industry awards, this smart technology-led solution is resulting in reduced energy use and lower capital spending.

Conclusion: the value of seeking more information

The quality of Costain's responses and the detail it gave exceeded our expectations. We have found smaller cap companies can tend to hide behind their size as an excuse for not providing more information, citing a lack of systems and resources. Costain, however, provided many examples of projects they're working on with clients, giving detail on exactly how they're helping them enhance their positive real-world impact and offset the negative.

Our enhanced engagement helped us to really appreciate Costain's consulting and advisory role, as well as the influence it has on introducing innovative solutions that enable clients to address regulatory commitments in a more thoughtful, sustainable and impactful way. While its case studies were plentiful and insightful, with good quantification of impact at the project level, unfortunately the measurements and metrics used are project-specific. It proved difficult to come up with an impact measurement metric applicable to Costain as a whole. Its examples stand at a point in time and are impossible to monitor for progress over time. Once again, we encountered the age-old problem of establishing standardised impact measurement.

Costain's work in relation to biodiversity impact and designing IT systems that help them manage projects better taking biodiversity as a key consideration is interesting. In fact, it serves as a jumping-off point in our conversations with other engineering firms we own to better understand their processes and strategies.

The metrics we have identified to monitor going forward are the:

1. **percentage of revenues from its legacy energy business** and how that's changing compared with exposure to renewables as we monitor its transition to focusing more on renewables

2. **number of customers that have benefited from better water quality and service reliability** due to Costain's work with water utilities

3. **percentage of its contracts having a net positive biodiversity impact** according to its internal measurement system.

iii - Consolidated Water: mixed visibility of key information

Consolidated Water owns and operates desalination plants and distribution systems in the Caribbean, mainly in Grand Cayman and in the Bahamas.

Consolidated Water's revenues align favourably with the UN SDGs, with a 100% positive alignment to SDG 6 (clean water and sanitation) given its plant engineering and desalination utility operations. Taking our assessment beyond revenue alignment of activities, we then applied the AP7 scoring methodology. We gave the company a score of 3.

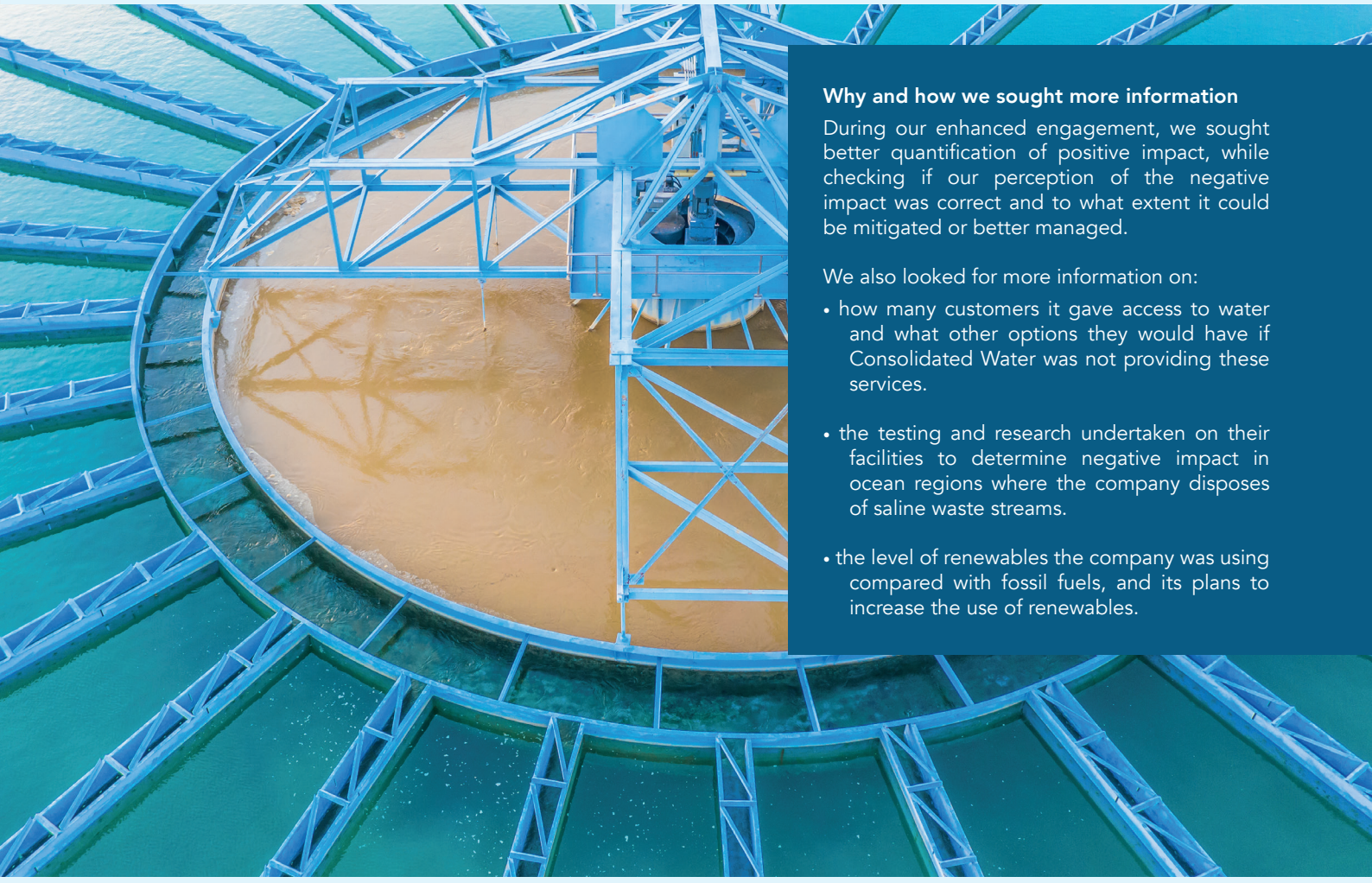
The basis of our scoring decision

The company supplies water to residential, commercial and government end users in areas where naturally occurring supplies of potable water are scarce. The level of additionality is high as it is increasing access to potable water where there is no alternative.

It also owns a plant engineering business, which incorporates a wide range of water equipment products, and provides design, engineering, operating and other services for water production, supply and treatment. Over recent years, it has been developing the largest desalination plant in the Western hemisphere in Rosarito, Mexico, another region with water scarcity issues.

The potential negative impact issues were a little more obvious for Consolidated Water than our other case study firms in this report, given its desalination activities. These are energy-intensive, often using fossil fuels [potentially negative to SDG 13 (climate action)], while the concentrated saline waste stream is dispersed back into the ocean, which may have detrimental localised negative impact to SDG 14 (life under water).

While we must balance this with the fact that Consolidated Water is operating in regions with no alternative source of water, we nevertheless deducted a point for this.



Why and how we sought more information

During our enhanced engagement, we sought better quantification of positive impact, while checking if our perception of the negative impact was correct and to what extent it could be mitigated or better managed.

We also looked for more information on:

- how many customers it gave access to water and what other options they would have if Consolidated Water was not providing these services.
- the testing and research undertaken on their facilities to determine negative impact in ocean regions where the company disposes of saline waste streams.
- the level of renewables the company was using compared with fossil fuels, and its plans to increase the use of renewables.

Responses from the company

Consolidated Water desalinates saline water and provides potable water to customers, primarily, on two islands – New Providence, The Bahamas (two plants) and Grand Cayman, Cayman Islands (six plants). It also manages and has a minority equity interest in an affiliated company on Tortola, British Virgin Islands.

New Providence and Grand Cayman are low-lying limestone islands without any appreciable amounts of naturally-occurring fresh water. Furthermore, any fresh or brackish groundwater occurring on New Providence has been contaminated by wastewater discharges from septic systems and surface water runoff.

There is no economical alternative to seawater desalination for public potable water supply on these two islands. The company does not dispose of its saline reject water in coastal waters off the Bahamas or the Cayman Islands. Instead, all its desalination plants on New Providence and Grand Cayman use deep injection wells for disposal of saline reject water. These wells vary in depth from 250 feet to more than 700 feet below groundwater level and are located several miles inland from the coast.

Regulators require the company to install and regularly test shallow monitoring wells in all sensitive groundwater areas to ensure the integrity of its deep injection well casings. Due to the cavernous nature of the subsurface strata in these islands, the depth of the deep injection wells and the density of the saline reject water (which is heavier than seawater), Consolidated Water does not believe there is any interaction between the saline reject water and coastal water, although it acknowledges it has not completed any studies in the area.

Finally, the company does not currently disclose how much electrical power and diesel fuel its plants consume in the Bahamas and the Cayman Islands but will consider making this information available in future.

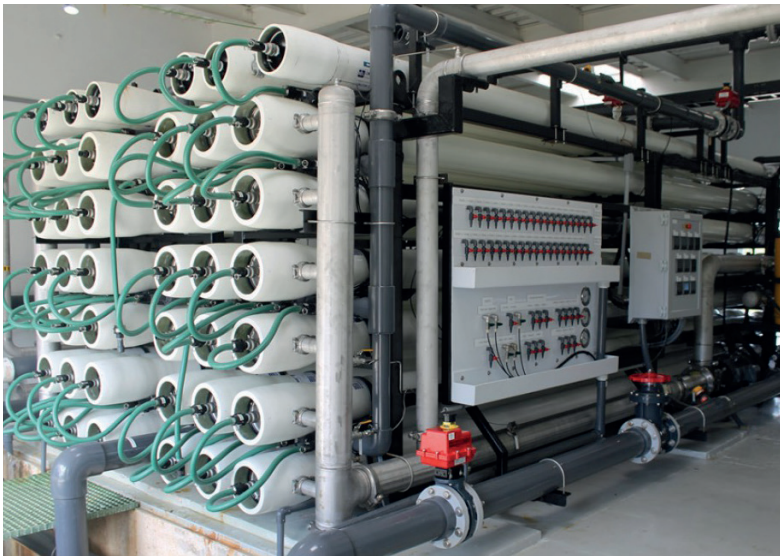
That said, the sources and forms of energy it uses to run its plants are dictated by local regulations and by contract. In Grand Cayman, for example, it must use the regulated electrical power utility on the island, Caribbean Utilities Co. Ltd. (CUC), as that firm has an exclusive licence with the Cayman Islands government to produce and supply electrical power throughout Grand Cayman.

Conclusion: the value of seeking more information

The desalination process has a widely known negative environmental impact, involving energy intensity and the waste stream associated with it. This tends to take the shine off what is a valuable solution, sometimes the only one providing potable water in certain parts of the world.

Getting a satisfactory explanation of how an experienced operator like Consolidated Water considers these issues was crucial. While its response on the waste stream was insightful and helpful, the information it shared on how it manages its energy use and thinks about improving its mix was less so.

We found a clear absence of detail in relation to energy usage and renewable targets. While this information may seem logical to deduce, as the company is obliged by contract with the local governments to use certain forms of energy from certain sources, it might also be too easy to accept this is outside their control.



We will continue to engage with Consolidated Water on this topic, while also doing some independent research into the energy transition plans for its providers.

The metrics we have identified to monitor are:

1. **the volume of water supplied**
2. **the percentage of energy sourced from renewables**
3. **more visible targets relating to biodiversity impact** and how it is measuring and offsetting this.

5. ASSESSING OUR ENHANCED ENGAGEMENT

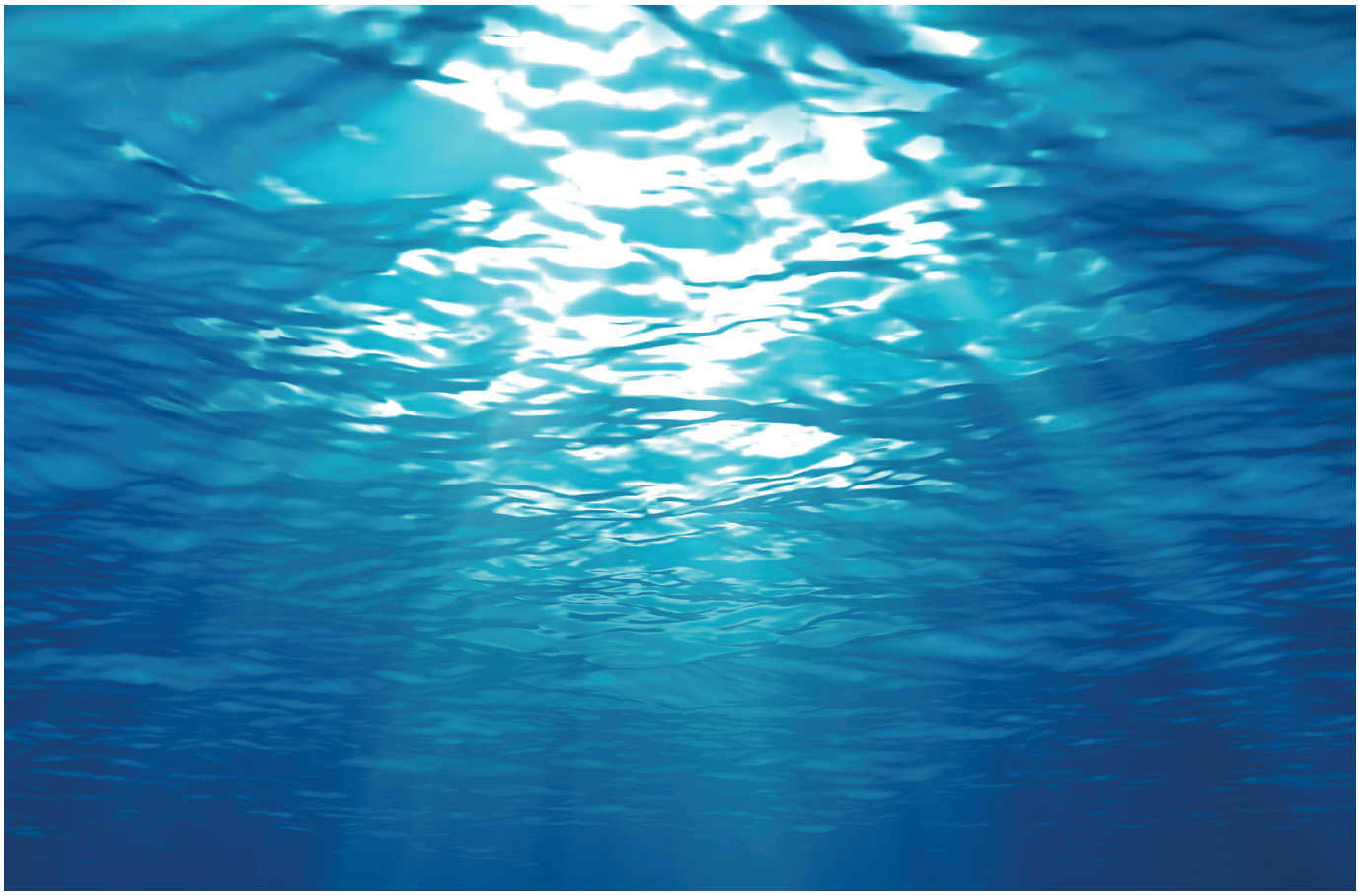
The enhanced engagement phase allowed us to go deeper on some specific areas of interest at company level. We wanted to enhance our knowledge, fill in information gaps and get quantification where possible on both positive and negative issues.

As when we embarked on our RASS project in 2017, the idea was to move away from positive impact anecdotes in favour of something more concrete and quantifiable as an expression of impact. While quantification is increasing, it's fair to say it remains ad hoc at best, still lacking a conclusive framework for calculation or any kind of standardisation across companies.

Many of our engagements ended up reverting to anecdotal evidence. Companies can often give good examples of impact at project level, but with hundreds of projects in many cases, there isn't a 'one metric fits all' approach.

That said, there are subsegments of the portfolio, such as utilities, that lend themselves to having a common set of impact indicators, such as:

- water quality enhancement
- new connection growth
- efficiency targets, for example, around leakage and energy.



Playing our part as active investors

Across companies, we found varying levels of responsiveness around both the quality and the quantity of information. Is it reasonable for some companies to be wary about publishing certain information for fear of future expectation or out of concern it will be deemed the wrong measurement when impending regulation finally emerges?

That's unsatisfactory if so. There is clear momentum behind better transparency and more quantification, so companies need to get on board or be left behind.

We take our role as active investors seriously. We're encouraging and guiding our companies on the information to report and activities to pursue. Our engagements have enabled us to get to the core of how deeply management teams - the allocators of capital - think about their impact footprint and handprint.

It has also meant we can differentiate between those that have impact clearly ingrained in their culture, operations (via monitoring systems) and strategy, compared with those where positive and negative impact are simply outcomes of their business activities.

The impact issues upon which we have focused will form the basis for future engagement and the start of a list that will no doubt grow as the information we gain leads to more questions and insights. We can monitor these and will push for better quantification when needed.

What constitutes a successful engagement with a company?

There are a couple of factors in our minds that lead to successful engagement with a company.

- There is a value to having a good relationship with the company, a 'direct line' so to speak. This is something we have the benefit of given our track record and experience investing in the water space and being active owners of our companies over long periods of time. Our deep understanding of the companies activities and frequent interactions with management place us in a good position to initiate impact related questions and furthermore for the companies to listen and want to give a satisfactory response.

- When engaging with our companies we tend to try guide them in their impact journey by giving them real life, 'best in class' examples from peers in the water space, in terms of the metrics to report on or the type of transparency of information that is desireable. We attempt to give them something tangible to aspire to, advancing our engagement goals.

- Regular monitoring and follow up after an initial engagement is very important, to demonstrate that this is a key issue for us and we want to see progress.

- Finally, in the interest of having a broad and diverse investor base, as is the goal of most companies, we make sure they are aware that there is a fast-growing share of their potential investor base that cares about Impact and ESG metrics, and if their concerns are not addressed, will be restricted from investing by their mandates, increasingly driven by regulation.

Key indicators of best practice

Finally, our engagement work has allowed us to identify six key indicators of best practice when it comes to measuring social and environmental impact.

These are:

1. High transparency and availability of information, for example, sustainability reports, engagement with MSCI, reporting to CDP (the not-for-profit that runs the global disclosure system for investors, companies and others to manage their environmental impacts)
2. Providing examples of real-world impact and quantifying that impact
3. Proof of consideration of footprint and addressing negative impact, such as that on biodiversity
4. Internal monitoring systems with the aim of avoiding or reducing negative impact
5. Consistent messaging through company communications with the market-targeting impact as part of company DNA
6. Targets around capital allocation prioritisation, product development spend, link to incentive structures for management

6. CURRENT REGULATORY CONSIDERATIONS

In the European Union in particular, there are relevant regulatory and/or legislative initiatives for impact investing, particularly for the information requirements needed to assess impact investing.

The EU's **Sustainable Taxonomy** regulations, which come into effect in phases from 2022 onwards, require investment managers to disclose the proportion of portfolios invested in "sustainable" economic activities, according to the extremely detailed criteria set out in the regulations. At a basic level, this gives investors additional transparency and somewhat regulates claims of sustainability by investment managers.

Perhaps more significantly for this project, these regulations may in turn force a much higher level of disclosure from companies on sustainability issues. If investment managers are forced to carry out a proper assessment of whether an investee company is sustainable, they are in turn likely to put pressure on investee companies to publish enough information to make that assessment possible. If a company doesn't do that, an investment manager will be less likely to invest in it.

Similarly, the introduction of new **Sustainable Finance Disclosure Regulations** (SFDR) in the EU could be significant, as they require a much higher level of disclosure from investment managers who manage investments with sustainability characteristics (known as Article 8 investments) or sustainability objectives (known as Article 9 investments).

In practice - although this was never the intention of policymakers - it seems quite likely that for investors these regulations become a type of label that many investors will require investment managers to comply with, and thus the number of investment funds and portfolios with Article 8 or 9 status is rising rapidly, which in turn forces greater disclosures on sustainability issues from investment managers.

The third set of new regulations, which are at a much earlier stage of the legislative process, are known as the **Corporate Sustainability Reporting Directive** (CSRD). They will require all companies listed on EU exchanges (and many other companies) to disclose a detailed set of sustainability data points and a broad range of sustainability information.

All three sets of regulations point firmly in the same direction - much greater focus on sustainability and far more mandatory disclosures of sustainability information by investee companies. This can only be helpful to impact investors and may mean enhanced engagement programmes such as that we had to carry out for this project won't be needed as much in future.

7. CONCLUSION: Measuring, understanding and influencing impact

Investing in global water stocks providing solutions to critical issues has an impact and undoubtedly serves to advance environmental and social goals. There is no doubt that measuring impact is definitional and difficult, with very few companies reporting on their impact, the availability of information varying significantly on a case-by-case basis with no two companies measuring impact the same way, and a multitude of avenues of impact. As active managers in the Water space we have not let the challenges in accessing clear information deter us. Instead, we have used it as a basis for engagement with our companies, encouraging increased transparency and quantification where possible.

This project shows that an in-depth knowledge of a company and its activities are necessary to go deeper and ask the right questions around impact. This process in turn has enabled us to identify the key impact issues for each company, meaning we can engage on them and monitor them going forward.

That will enhance the quality of information on impact that we get from our companies and enable us to build on it to develop better insights.

The process has also allowed us to identify best practice and strive to encourage companies to follow this. Ultimately, this could enable some standardisation of impact quantification for companies with similar business models and activities.

As active managers in listed water companies, we have a core role to play in understanding, measuring and influencing the impact of these companies on the environment and society as a whole.

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