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To the last drop: A sustainable investor's view on water scarcity in China

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Some of China's richest and most populous areas - cities like Beijing or Tianjin - are facing enormous risks when it comes to accessing one of the most basic necessities of life: clean water.

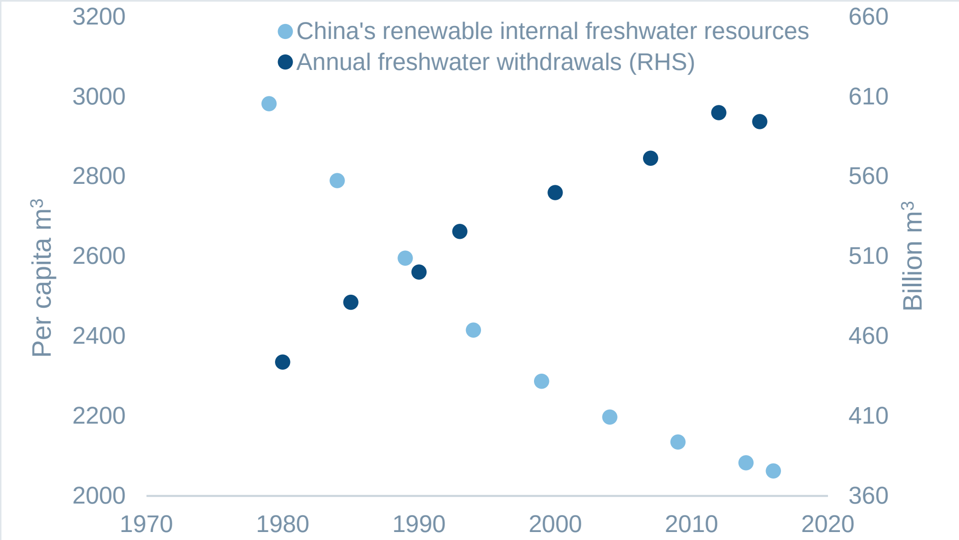
China's supply of renewable fresh water is low, at only about a third of the global average on a per capita basis. Worse still, across wide swathes of the country, mainly in the arid northern provinces, that measure dips to levels that signal acute scarcity. It could be China's undoing. While China is the world's most populous country and remains one of the fastest growing major economies, water scarcity could halt or undo so much of this development. Former premier Wen Jiabao, a geologist by training, once said water shortages threatened "the very survival of the Chinese nation". It's an issue for China's neighbours too, as water flow in the rivers of Southeast Asia are diminished by dams China is building upstream.

Investing sustainably in sustainability: Water use

China's water woes are the result of myriad factors including rapid and sometimes footloose urbanisation and industrialisation. From a sustainable investor's perspective, they represent significant challenges, but they also present distinct opportunities. New policies and regulations are creating liabilities for companies ranging from obvious consumers of water such as crop producers, power plants and brewers as well as less obvious businesses like microchip manufacturers and textile mills. But at the same time, aggressive government spending to improve wastewater management and ensure clean drinking water is stoking massive demand for environmental technology and related services.

The key question for investors is how to access these opportunities. A number of multinational water or environmental services firms have made significant inroads in China, companies like Suez Environment, Veolia Environment or Xylem. And while foreign firms may have technological know-how, it is often local firms that have an edge when it comes to market knowledge and licenses to operate - many foreign companies access China by forming joint ventures. Local players include firms like Beijing Enterprises Water or China Everbright International.

Chart 1: Water scarcity is worsening in China, as rising consumption adds pressure to renewable resources



Source: World Bank, Fidelity International, April 2019.

And while companies jostle for position in the highly fragmented and fast-developing market, the sector remains exposed to the usual governance risks of investing in new and emerging markets. Although these companies are providing solutions to the country's water challenges, investors in China must not forget the importance of corporate governance because good quality businesses begin with good management. Investors in the sector should take a global view toward sustainable investing, but it's helpful to augment this with careful on-the-ground research, in order to help identify the companies most likely to succeed.

Polluter Pays

The market is massive and growing. The challenge is that China is fighting pollution on several fronts - air pollution is the most visible, but solid waste and soil pollutants are equally large problems.

Estimates range widely, but according to some projections, the domestic market for soil remediation will grow to 685.6 billion renminbi, or over $100 billion, by 2020.[1] Thousands of companies have piled into China's soil remediation market in recent years.

The stakes have been rising more recently, driven in large part by regulatory developments in China. On January 1, a sweeping new law targeting soil and groundwater pollution took effect, putting greater responsibility on all land users, not just factories, to prevent polluting their premises and to tackle pollution they may have already put in to the environment.[2] Significantly, this law extends to groundwater pollutants.

The law is China's first comprehensive legislation covering pollution, and while enforcement will be a challenge it introduces specific individual obligations for users or would-be occupants of land. It empowers local authorities to enforce measures with fines for breeches of up 2 million renminbi (around US$300,000) and the threat of administrative detention.

Investing for sustainability

Top-down planning features prominently in China and in the country's 12th Five-Year Plan, which covered 2011–2015, water security was placed at the top of the agenda.[3] The 13th Five-Year Plan, which runs until 2020, builds on this. Government spending worth hundreds of billions of dollars will see new reservoirs, water diversion projects, irrigation projects, and hydropower plants. Further large-scale investments include wastewater treatment facilities and infrastructure and municipal drinking water.

At the same time, China's policymakers are targeting conservation among end users. They have promised market-based reforms designed to reduce water use and encourage water recycling and reclamation at the industrial level. But they also include proposals to increase retail tariffs on water and implement tiered pricing for household consumption.

Investment Implications: Walking the talk

To make the most of the prevailing trend in China towards water sustainability, investors can, we believe, benefit from applying environmental, social and governance (ESG) factors in their investment process. This is one way for capital allocation to have the most impact on environmental conditions.

As water has grown in prominence as a key input to the production process, it has become a risk factor for industrial companies operating in China. Fidelity recently engaged with a number of investee companies in Asia on the ESG-related risks in their supply chains. We focussed on the clothing retail, textiles and luxury goods sectors, where the multi-layered structure of supply chains can expose companies to reputational, operational and legal or regulatory risks.

Among the environmental factors covered in the engagement was water management and specifically, what companies are doing to limit their impact on water resources. The goal is to benchmark current water conservation and reclamation practices and identify areas where we can work together with companies to deepen their commitments in this area. Companies that are operating in high water-risk areas or in industries where water is a key component of their production process need to have strategic plans to manage and - where possible - to reduce their impact on this scarce resource.

Conclusion

China's water scarcity challenges are daunting, but they create distinct opportunities when it comes to seeking sustainable investment strategies, mainly for companies providing water treatment solutions. Companies that operate in water-intensive sectors or high water-risk areas will need to actively and carefully manage their water use in order to lower operating expenses, maintain their licenses to operate and emerge as winners in the long run. Adapting to these challenges and seizing the related opportunities requires a proactive and engaged approach. For China, the stakes couldn't be higher.

References

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