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Steady Fundamentals for Water and Waste

Regnan Sustainable Water and Waste Strategy

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FOR PROFESSIONAL INVESTORS ONLY

The macro picture has been challenging, particularly with uncertainty on the likely peak of the interest rate cycle. Company specific fundamentals remain positive, supported by stable earnings and corporate activity.

Equity market see-saw continues

After having a tough 2022, global equity markets started 2023 on a strong footing. Signs of easing inflation supported sentiment and the market started to weigh in on expectations of a peak in interest rates. Sentiment also got a boost from China dropping its zero-Covid policy. Given the backdrop, growth-oriented sectors like consumer discretionary and technology led the rally, significantly outperforming more traditional defensive sectors like healthcare, utilities and consumer staples. This was a reversal trade of what had happened in the full-year 2022. The seesaw pattern continued in February 2023, as global equity markets fell during the month.

The old adage of 'good news' is 'bad news' continued in the market. With economic data not indicating an imminent recession, the market was forced to reassess the interest rate path. Central banks across the US, Europe and UK announced rate hikes as expected. We believe that the accompanied commentary with the rate hikes led the market to factor in a higher-for-longer scenario. With strong labour market data, we believe wage inflation remains entrenched in the system, which supports the higher for longer narrative. However, as seen in previous cycles, the labour market can turn very quickly, and it is one of the key data points to keep a close eye on.

The collapse of SVB and Signature Bank have raised questions on financial stability and liquidity. Attention has subsequently turned to Credit Suisse. In our view, risk of contagion remains relatively small but this doesn't make the Fed's job any easier. Looser conditions would support the financial sector, but inflation suggests the need to maintain tightness.

Water has recently outperformed waste

As a collective group, both integrated solid waste and industrial waste beat the broader market in 2022. Most of this outperformance came in the first 3 quarters of the year led by three fundamentals:

1. Pricing – where our companies could easily price through inflation
2. Good volumes – new business formation was better than forecast; and
3. Mergers and acquisitions – 2022 was another good year for corporate activity.

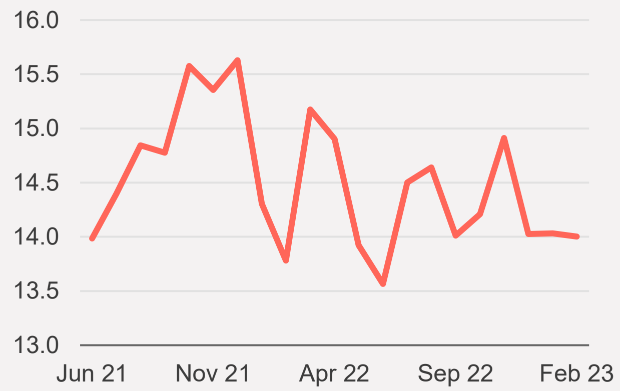
We benefited from the corporate activity with our portfolio as one of our UK-waste names was also taken over. The recent underperformance in waste can partially be attributed to the reversal trade that we are seeing in the market. A few of our companies saw multiple expansion early in the year, some of which has been given back as the market appears to be focussing more on cyclical names. However, our industrial waste names have done well on the back of the cyclical rally.

What matters to the long-term investor is the fundamentals, which remain strong. We expect overall earnings and free cash flow to be up year-on-year for our companies in 2023. The current share prices are factoring in a slowdown, especially in the 2nd half of the year. If we were to see a soft landing which is what the broader market expects, these stocks can rerate quickly. We also expect M&A activity to continue albeit the focus will be mostly on smaller deals, and not platform acquisitions.

To reiterate what we have said in the past – this is why it is important to combine both water and waste. We had booked some profit in our large cap waste names and initiated a position in a Chinese waste name which has done well in recent months. We also increased our exposure to sustainable packaging and to a small-cap UK water name. As always highlighting the importance of bottom-up research, looking across the value chain and being active.

Average valuation for Integrated US Waste names has come down in recent months

EV/ EBITDA



Source: Regnan, Bloomberg. Average EV/EBITDA for the largest 5 US integrated waste companies.

Looking into earnings season

The overall earnings season for our companies was broadly in line with our expectations apart from a couple of surprises. Broadly, waste-related companies had a good calendar Q4 2022. Pricing was better than expected and opened strong for 2023. Sustainable investing capex plans were a key theme across multiple companies and will be a focus area in the coming years.

For water equipment companies, the last quarter was dominated by inventory reductions which were putting pressure on manufacturing demand. Management commentaries suggested that some of the inventory destocking trends have stabilised. Still, there was caution in some of the outlook commentaries with external headwinds. There were also tailwinds from carry-over pricing and productivity. Companies like Watts Water and Pentair focussed on taking action on ‘cost structure’, which will offset potential moderation in demand. Guidance around capex spending for 2023 was also supportive of long-term growth plans with reshoring/supply chain investments taking strategic priorities.

Water utilities continued to have a tough run seeing multiple compression and facing macro challenges including higher inflation and interest rates. Nevertheless, their stable earnings model bodes well in an uncertain macro environment.

Stand-out earnings included A.O. Smith (water heating and treatment equipment) and Mueller Industries (copper tube and fittings) on the positive, and Advanced Drainage Systems (stormwater and septic wastewater) on the negative. A.O. Smith offered better-than-expected guidance and the stock rallied on short covering. Mueller Industries had a strong 2022 with the company executing well despite negative the impact of lower copper prices on the top line. Advanced Drainage stock came under pressure as it missed estimates and cut guidance for a second consecutive quarter. This was driven by weakness in the residential market further amplified by destocking and some weakening in the non-residential segment as well. We have reduced our exposure to the name and do not expect any major catalysts in the next two quarters as there is no obvious price/cost or demand positive revision. We will continue to monitor the stock closely and might look to add to the position once again depending on fundamental and economic developments through the year.

Purity back in the conversation

Our investors have always wanted us to have an elevated level of thematic purity both at a stock and portfolio level. A few of the stocks that have come up in conversations include Danaher and PerkinElmer, both of which have been in the news recently.

Danaher announced in late 2022 its intention to separate its Environmental & Applied Solutions segment (c 16% of the company) to create an independent, publicly traded company. The new company will be comprised of Danaher's Water Quality and Product Identification businesses. As announced in February 2023, the new company will be named Veralto[1]. We will be keeping a close eye on the development of this deal (expected to complete in Q4 2023) but in our view, had management decided to spin off just the water business as a stand-alone pure-play water business would have attracted suitors with buy-out offers.

In the second half of 2022, PerkinElmer announced that it will be divesting its food safety, environmental testing and industrial quality assurance divisions to focus on its core life sciences and diagnostics business. Any water-focussed fund holding PerkinElmer became forced sellers of the stock as the company now had no water exposure.

Source: [1]https://investors.danaher.com/2023-02-08-Danaher-Announces-New-Environmental-and-Applied-Solutions-Company-to-Be-Named-Veralto

As companies start to strategically focus on core businesses and cutting costs, there might be more such deals that come our way. Therefore, in our view, it is important to focus on thematic purity and avoid stocks with low stock-level thematic exposure.

Back to fundamentals

As difficult as it is to make a call on near-term macro-outlook, this year feels more difficult than average to provide a firm outlook. We are at a crossroads where data from various segments and regions will drive the direction of the market. We are currently in one of the most aggressive hiking cycles in history and it hasn’t finished yet. Equity markets have been led by rates volatility and expectation around rates. This trend is expected to continue until macro trends become clear.

Market sentiment has been hurt further following the collapse of SVB and Signature Bank as financial stability and liquidity concerns entered the conversation. We do not have any direct exposure to banks and do not believe that any of our major holdings had major banking relationships with either SVB or Signature. Nevertheless, the combination of a still-strong macro backdrop and risks around the banking system has made the Fed path highly uncertain. This reinforces our believe that short-term market movement will be heavily linked to Fed commentary.

Since Q4 2022, strategists have been calling between an imminent recession (caused by the central banks) to no recession (which will lead the central banks to cause one). A recent Bloomberg Survey showed that the market is split between a soft and hard landing with neither situation getting more than a 50% response. Google Trends searches also indicate that the market is increasingly hoping for a soft landing, a trend we have seen in previous crises. In our view, as things currently stand, a case can be easily built for either scenario. We believe that volatility in the market will continue this year. We expect the inflationary pressures of 2022 to impact demand in 2023 with fears of a global slowdown and unemployment rates picking up from low levels, especially in the second half of the year.

In this environment, we believe real assets and related core services with asset-backed cash flows are likely to present opportunities. In our view, the water and waste thematics continue to offer sound valuation, with favourable ROE, net debt and cash flow characteristics. We stay diversified within our portfolio, focusing on bottom-up stock selection. Similar to last year, we expect volatility to create buying opportunities. Any reallocation in sizing and industries within our universe will emerge from the earnings seasons to remove uncertainties from the “real” economics and reset valuation opportunities.

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