Water Asset Management, LLC.
509 Madison Avenue, Suite 804
New York, N.Y. 10022
1-212-754-5132 Tel
1-212-754-5101 Fax

WAM's Corona Chronicles III

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First and foremost, we all wish you and yours good health.

The year-to-date performance for WAM's TRF Global Water Equity long/short fund and The Global Water Equity long only fund is -12.51% and -16.09%, respectively.

The corona virus impacted world is now realizing what WAM and the water industry have long known. Low cost at any cost - is not only expensive in the long run, but can be fatal.

Complex, long distance global supply chains developed by manufacturers in a low cost race to the bottom have revealed that the lowest cost also comes with increased risk and vulnerability after someone in Wuhan ate a snake, bitten by a bat, and sneezed…

Whether in the U.S. or the Philippines, the water utility industry long ago learned that water must be appropriately priced to cover all necessary, sustainable operating and capital costs – including a return on debt and equity. This business model ensures a reliable and safe long-term water supply with accountability.

Water utilities have always been considered a distributed healthcare service to preventing the spread of water born diseases. Water's connection to public health is taking on heightened importance as water, soap, and hand washing is literally the first line of defense against the global corona pandemic. It's a travesty that billions in the developing world, where social distancing is even more problematic, lack basic water access. This lack of access to water will likely become even more disastrous when corona spreads there unchecked by normal hand washing.

The Funds' investor-owned regulated water utility companies have business models which have been delivering clean reliable water for decades. That is the definition of positive impact. At the same time, the utility business models allow tariffs to recover all prudently incurred operating costs, as well as a return on capital expenditures, which ensures that sufficient capital is invested over the long-term to maintain a robust water network. Additionally, investor owned water utilities often implement tiered volumetric pricing, i.e., the more water used the more one pays per liter, which promotes conservation and efficiency, justice, and affordability.

Most predominantly, it is the water utility systems operated by governments, which have most often ignored the need for full cost pricing, that present increased water risk to their populations.

The corona pandemic has also abruptly awakened most other industries to the reality, and expense likely to come as they shorten their low cost, international long-distance supply chains closer to their end markets. Corona has also accelerated the end of what is likely to be the last chapter of the post-World War II, unfettered, globalized economic and geopolitical system. This will create many winners and many losers among nations, industries, and companies.

Among the winners will be the water companies and the agriculture properties with water rights that WAM invests in, which are all local businesses, often monopolies and oligopolies.

Geopolitical strategist, Peter Zeihan, writes that industries like automotive, pharmaceuticals, textiles, technology, heavy machinery, electronics, and semiconductors – all with complex supply chains, face serious risk. The typical car has 30,000 parts that come from all over the world and the car manufacturer usually has no idea who its tier 4 suppliers are, let alone its tier 6. This is likely to change, increasing costs to consumers, and combined with the trillions of deficit spending stimulus could eventually lead to inflation.

As more industrial production repatriates to the U.S. higher local costs will be somewhat offset by increased automation, cheap American electricity, and massive global overcapacity of oil, natural gas, and commodities. The shortening of supply chains will also increase the industrial demand for local water supplies in the US, many of which are scarce and getting scarcer due to climate change. WAM invests in those companies and assets that will enable that increased industrial demand for water to be met.

When compared with other types of core infrastructure and real assets, water is also insulated from demand destruction, in what will be the post-corona economy. For example, airports may see less air travel and ports fewer shipping containers, for some time to come. Bridges, toll roads, parking and roads may have less traffic, and office buildings may lose tenants as flexible work and virtual meetings become the norm. Oil and gas is in historic oversupply…

These considerations lead us to build our portfolios of the best water companies in the world, with a renewed emphasis on those located in the U.S. and U.K. We anticipate investing less in water companies in China, EM, and Europe, where even marginally less "globalization" in the post corona aftermath may challenge the long-term growth of those economies.

Ed Hyman, at the economics research firm, Evercore-ISI, expects U.S. GDP to be down 50% this quarter (yes, 50%!). Fortunately, the USA has the world's only reserve currency which has enabled the Fed and Treasury to act swiftly, and at a multi-trillion-dollar scale.

The question is whether the trillions of dollars of stimulus and payment protection for millions of businesses to pay salaries, rent, mortgages and utility bills (including water) will have enough velocity to "quickly" restart the deeply interconnected, unknowingly complex, and highly leveraged economy, as quickly as a lawn mower, and without a hiccup; while avoiding another mortgage crisis, euro crisis, or the implosion of the overleveraged Chinese or an EM economy.

It's a massive challenge. There are more than 30 million U.S. small businesses with less than 500 employees, comprising 50% of all American workers, according to the SBA. Most are shut down. There are now 15 million people estimated to be out of work in restaurants alone. While the situation is bleak, investors do know now more than we did in late March. We know that the fiscal and monetary stimulus is massive, the case curves are flattening, and hundreds of promising corona therapies and vaccines are in development.

That said, WAM's summary analysis of worse case scenarios from COVID-19 on our portfolio companies is as follows.

For our U.S. and U.K. regulated utilities, the worst case impact from COVID-19 will be manageable, due to strong balance sheets, and constructive regulatory models. Importantly, the Fund's water utilities have liquidity with investment grade balance sheets and the ability to access capital markets, when needed. Our worst-case EPS hit assumes a severe 75% water usage reduction for Business and Commercial customers (~25% of overall revenues) over 3 & 6 month periods – with existing regulatory measures and cost cuts cushioning the full impact. Under this scenario, we project an EPS hit in the range of mid to high single digits. Although this worst case earning impact would be meaningful, we remain confident that any reduced EPS for our U.S and UK regulated utilities would be temporary, not permanent, as may be the case for many other companies in other industries.

This is due to the fact that **a)** The water utilities have existing regulatory measures to recover the lower revenues stemming from lower water usage/volumes and **b)** utilities will continue their cap-ex programs (there may be some short-term deferrals due to 'shelter in place' and social distancing rules). This enables them to continue growing their asset/rate base, over the medium-to-long-term, which increases earning per share.

Our worse case downside analysis for U.S. and European water infrastructure companies assumes significant end market declines, ranging from 10% to over 50%, and a higher than normal impact to margins given the rapidness of the decline. The results highlight the financial strength of our water company universe. Even in this extreme downside scenario, the median net debt to EBITDA ratio remained ~2.3 x with median interest coverage (EBITDA – Capex / Interest) at 5x. The companies have no significant maturities until 2023 or later and ample flexibility on undrawn revolvers. Even under this pressure tested analysis we also expect ~90% of these companies to continue to generate positive net free cash flow from operations, prior to additional significant working capital benefits (albeit one time in nature). Over the long term, we ultimately expect these companies to generate record earnings as they will ultimately utilize their strong balance sheets to gain market share from undercapitalized competitors.

In closing, we would like to share this quote from Noble laureate and existential author Albert Camus' The Plague. "What we learn in time of pestilence is that there are more things to admire in men than to despise... By refusing to bow down to pestilence, they strive to their utmost to be healers."

This succinctly describes those in the water industry.

Sincerely,

Matthew J. Diserio
President

Disque D. Deane, Jr.
CIO