



A Franklin Templeton Company

U.K. Water: Flat or Bubbly?

25 June 2024

Key Takeaways

- ▶ Political turmoil in the U.K., with a snap election and a water regulator ruling set for early July, looks to continue some near-term volatility for the U.K. listed water sector, which is also being unduly discounted due to trouble at an unlisted peer.
- ▶ Near-term political volatility could represent a buying opportunity for listed U.K. water utilities, whose spending on improving environmental impacts adds to the bottom line, as investments can earn attractive allowed returns, which translates to better earnings and dividends.
- ▶ The listed water infrastructure companies in which ClearBridge is most interested are leaders in environmental responsibility with strong track records and targets for environmental performance that we believe the regulator and investors will reward over time.

Political Volatility Could Represent Buying Opportunity

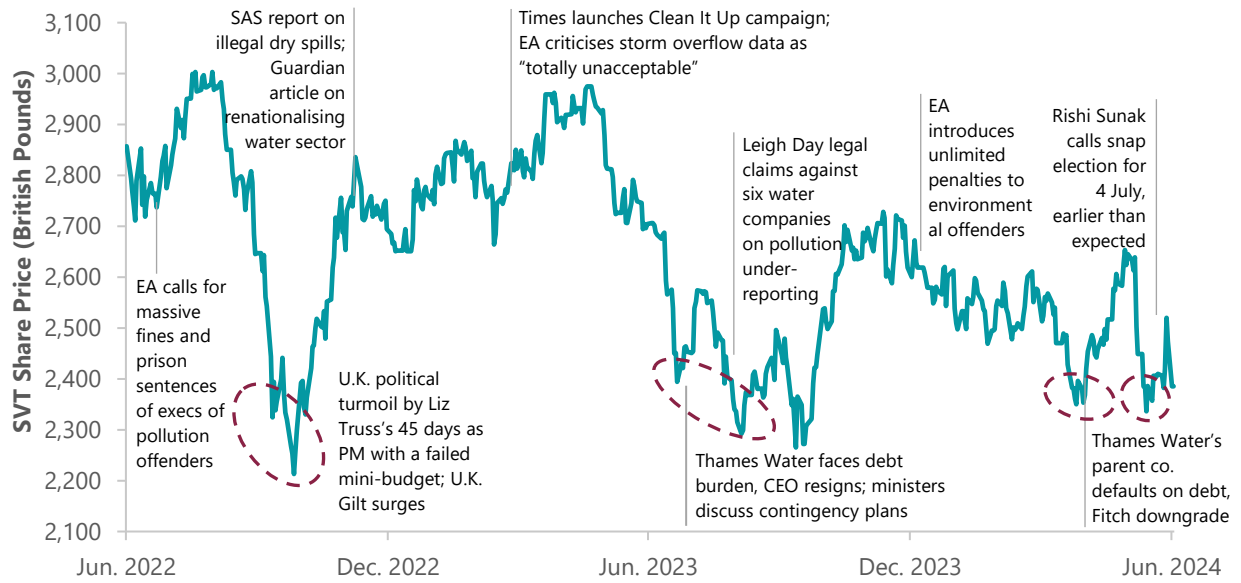
U.K. water utilities have been volatile in recent quarters as government and regulator action to reduce and remediate freshwater pollution have thrown these companies into the spotlight. In 2023, weather was no friend to the utilities, as storm water pollution was the highest on record and led to calls for an environmental emergency. The issue is made more urgent by climate change, which is expected to increase rainfall levels, further challenging storm overflow systems.

With the governing Tories calling a snap election for July 4, political turmoil in the U.K. looks to continue this volatility, especially as the water regulator Ofwat is scheduled to announce its draft determinations regarding water utilities' business plans on July 11.

This volatility could, however, represent a buying opportunity for listed U.K. water utilities, some of which are taking action to solve freshwater pollution through investments in their 2025-2030 business plans. Over the next five-year regulatory cycle, the sector as a whole is proposing to invest £100 billion, or nearly double what was invested in the past five years. In the case of Pennon, Severn Trent and United Utilities, these water utilities have proposed a total of £32 billion of investment, largely to address sewage spillage issues and to replace aging infrastructure. Such spending on improving environmental impacts adds to the bottom line, as investments can earn attractive allowed returns, which translates to better earnings and dividends.

Listed water companies have also recently been weighed down by sentiment related to the temporary nationalisation debate gaining traction for unlisted water utility Thames Water — although this is idiosyncratic and is unduly discounting shares for the sector, further supporting opportunities. As an example, Severn Trent has seen some price volatility over the past two years — which has presented buying opportunities, especially when shares were hit by political headlines or Thames Water (Exhibit 1).

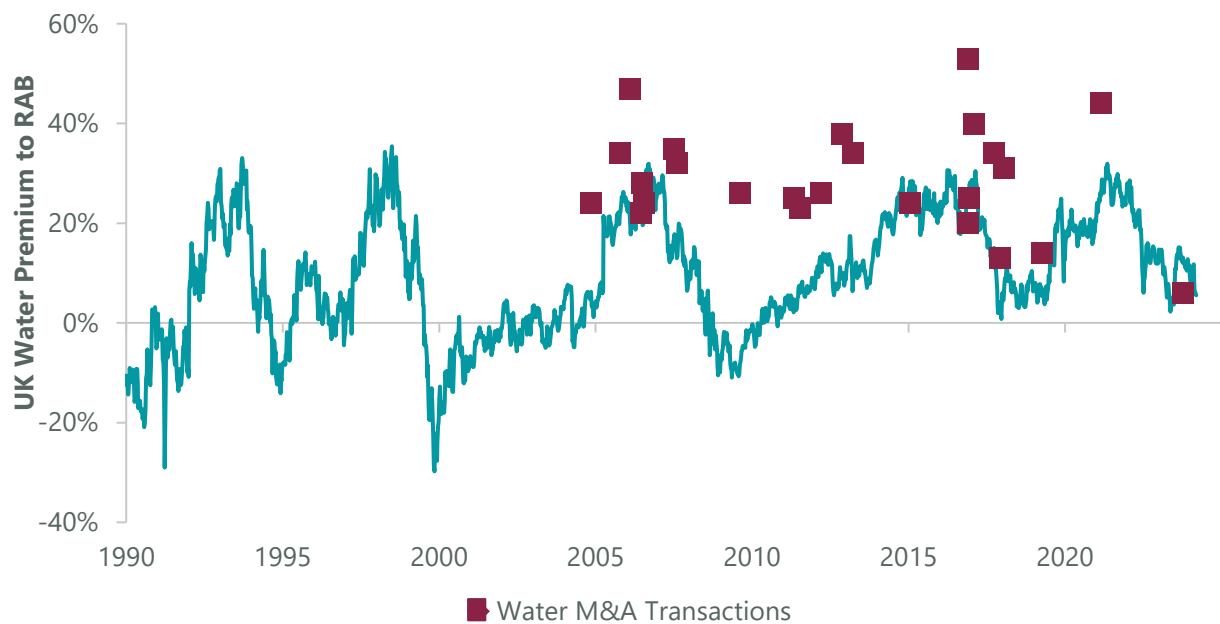
Exhibit 1: U.K. Water Sector Volatility Case Study: Severn Trent



As of 20 June 2024. Source: ClearBridge Investments. EA: Environment Agency, a non-departmental body sponsored by the U.K. government's Department for Environment, Food and Rural Affairs to protect and enhance the environment in England. SAS: Surfers Against Sewage.

Meanwhile, freshwater pollution remains a key biodiversity issue for the water utilities in the U.K., and one ClearBridge has been discussing with the companies. The listed water infrastructure companies in which ClearBridge is most interested are, in our view, squarely on the responsible side of spectrum in terms of managing this freshwater pollution risks, as they are in general when it comes to environmental issues. These companies also tend to trade at a premium to their regulatory asset bases, with private M&A transactions generally also at a premium (Exhibit 2), with currently depressed valuations representing what we see as attractive entry points.

Exhibit 2: Listed U.K. Water Premium to Regulatory Asset Bases



As of 20 June 2024. Source: ClearBridge Investments. Chart shows ratio of enterprise value to regulatory asset bases, our preferred valuation measure for U.K. listed water infrastructure, of Pennon, Severn Trent and United Utilities.

Environmental improvements are at the heart of the companies' investment plans currently before the regulator: Pennon's subsidiary South West Water, for example, will invest £2.8 billion in water quality and resilience and will aim to upgrade one-third of its water treatment works, complete its storm overflow investment 10 years ahead of target and achieve the lowest in sector pollution levels, with zero "serious" pollutions. Severn Trent will spend £12.9 billion and aim to improve at least 562 storm overflows and meet the government's targets five years early. United Utilities will spend £13.7 billion to reduce storm overflow spills by 60% over the decade to 2030, fix leaks and replace 950 kilometres of old pipes and mains.

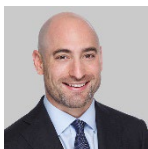
Severn Trent has strong targets to reduce water quality complaints, external and internal sewer flooding, supply interruptions and leakage. For instance, it targets 16% leakage reduction and 30% reduction in both average number of storm overflow spills and pollution incidents by 2030 compared to 2025 forecast. It achieved a 4-star top Environmental Performance Assessment (EPA) rating in 2023 for the fourth consecutive year and was confident it would maintain that for another year. It recorded no serious pollutions in 2023.

Pennon has ambitious targets of 100% bathing water quality all-year round and tackling 100% of storm overflows at all bathing beaches, 20 years ahead of the government's mandated target. It aims to reduce leakage by 19% in the South West region, achieving an industry-leading level of less than 10% leakage levels across all of its region by 2030 compared to 2020. In 2023 it was upgraded from a 1-star to 2-star EPA rating, with a target of 4-star for 2025. Its internal sewer flooding incidents (per connections) was the lowest in the sector.

Last but not least, United Utilities' environmental commitments and achievements are notable. It has established stretching targets across leakage, supply interruptions and water quality complaints. For instance, it targets to reduce pollutions by 37%, leakage by 25%, and internal sewer flooding by 32% by 2030. It has a sector-leading track record of minimising pollution over the past decade, having achieved upper EPA ratings of 3-star or 4-star ever since records began in 2011, including 3-star in 2023, and zero serious pollution incidents in 2019, 2020 and 2022.

Environmental issues and political turmoil look set to pressure U.K. water companies in the near term, but we see winners in the space whose responsible environmental stewardship and spending plans to further remediate pollution should be rewarded by the regulator and, before long, by investors as well.

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