PICTET FUNDS

PF(LUX)-Water

News from the Advisory Board

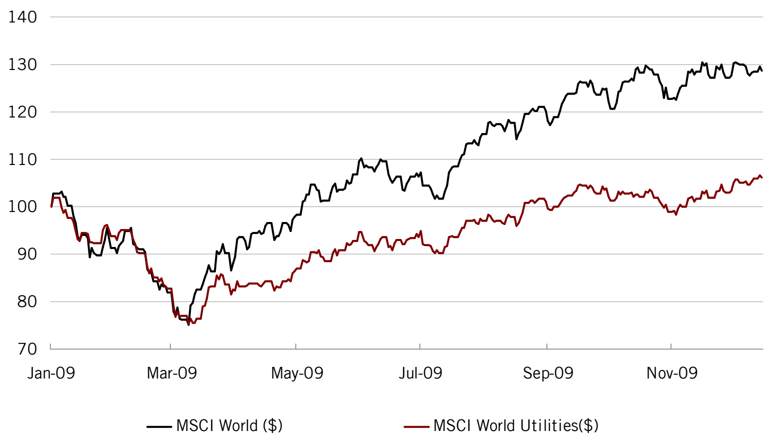
December 2009

The second semi-annual PF(LUX)-Water Advisory Board meeting took place in Paris. The most important items to come out of the meeting are summarised below.

Tough year for Water Suppliers

While 2009 was finally a good year for equities in general, with the MSCI World index posting over 25% year-to-date performance, it was comparably tough for utility stocks. Utilities underperformed world equities by approximately 23% over the period, making it the least attractive segment for equity investors this year. This picture is not a surprise. Many investors did focus on sectors more geared towards economic recovery and were willing to take exceptionally high risks in equity investing. Utility stocks, traditionally defensive plays, were out of favour in such an environment.

GRAPH 1: YTD PERFORMANCE OF MSCI WORLD UTILITIES VERSUS MSCI WORLD (IN USD)



Source: Pictet, as per 15 December 2009

In the UK, one of the large regulated markets for water services, Water Suppliers were negatively impacted by the review for 2010-2014 of the Water Services Regulation Authority (OFWAT), which regulates the water markets for England and Wales. The authority reduced the return target to 4.5%, from a slightly higher 5.1%. This put additional pressure on the stock prices of companies like United Utilities or Severn Trent. In return, the downside risk for further pressure on stock prices seems to be rather limited now. The Water Suppliers that are subject to the price regime of OFWAT have a market capitalisation that is now much in line with their regulated asset value. It speaks in their favour that they were always able to provide stable and relatively high dividend yields. But, given this rigid price framework, they only have limited upside in the short to medium term.

PPP mainly driven by China

China (PR) considers Water a key resource in the future development of the national economy. The government is putting a lot of effort into beefing up the infrastructure and upgrading the technologies installed. The number of areas with high population density is growing not only along the country's coastline, but also in more central provinces. As a consequence of this stated interest in developing the water activities, private-sector participation in China is growing considerably. Public-Private Partnerships (PPP) have the advantage of allowing public authorities to benefit from the private expertise and/or funding. In 1989, China accounted for 8% of the world population served by the private water sector worldwide, against 38% in 2009. During this first decade of the 21st century, China accounts for more than 50% of contract awards in population terms in every single year. As the most populous country in the world, China has become a very important source of growth for the global water market. Participants do not expect this to change in the foreseeable future.

Emergence of new local players…

A side effect of the development of private-sector participation in developing countries is the emergence of new local players, an activity that almost did not exist 10 years ago. While the number of people served by the multinationals has remained relatively stable since 1990, there has been an appreciable shift towards contracts run by local companies. This is not only true for China, but also for the fast-growing water markets of Brazil or Indonesia. This is well reflected in the increase in the number of small-to mid size contract awards being made in 2nd or 3rd tier cities. Global players do not have sufficient political connections and pricing flexibility yet to benefit from these opportunities as the market moves to more outlying areas.

TABLE 1: PEOPLE SERVED BY PRIVATE WATER OR SEWERAGE SERVICES IN 2009 AND FORECAST FOR SERVICE IN 2015 AND 2025

	2009		2015		2025	
Western Europe	181.4	45%	219.5	54%	226.6	55%
C&E Europe	33.8	10%	64.4	20%	81.1	27%
ME & Africa	69.2	5%	123.1	9%	217.8	13%
South & Central Asia	10.1	1%	43.1	2%	97.4	5%
South East Asia	314.6	15%	443.6	20%	605.2	26%
Oceania	10.1	28%	12.1	32%	14.7	36%
North America	100.4	22%	136.2	28%	209.0	40%
Latin America	86.0	18%	121.5	24%	158.0	29%
World Total	**805.6**	**12%**	**1163.4**	**16%**	**1600.8**	**20%**

Source: Global Water Intelligence

…and bigger regional players in Emerging Markets in the Water Supply and Technology spaces

In parallel, Asian regional players show up more aggressively on the market place. They are pro-actively developing their businesses outside the region. As an example, the Singaporean company Hyflux will build the world's largest seawater desalination plant in Algeria, with a project value of USD 468 million. The company formed as well a joint venture with SEDCO (Saudi Economic Development Company) and LUBREC (Lube Oil Re-refining Co) to jointly invest in a used oil recycling plant in Saudi Arabia. However, even though these companies are gaining in competitiveness and business coverage, they still lack experience and expertise of international markets (with regard to processes and equipment, etc.) to fully compete with Western players. Partnerships and joint ventures are a perfect tool for them to fill the existing technology and knowhow gap over-time. Nevertheless, it will still take some time until US or European companies are facing margin erosions, but it will be wise for them to prepare for that day.

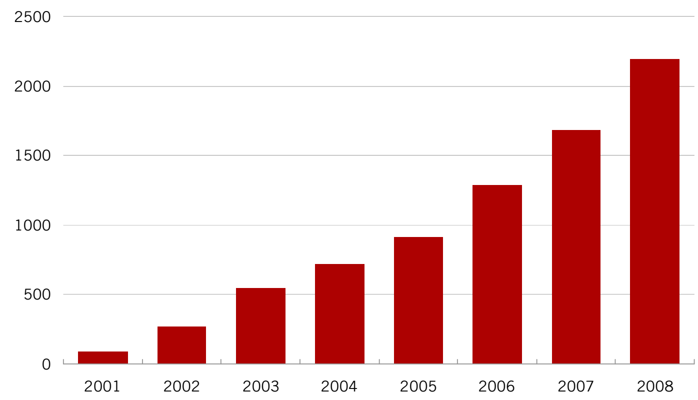
Product commoditisation in Water Technology

Water Technology is moving towards a commoditisation of the products as value increasingly resides in the process. Know-how on products and equipment is indeed easily accessible by emerging countries. By way of illustration, membranes are becoming more of a commodity market as the Chinese are acquiring the technology to make the membranes and sell them at a lower price while providing good quality. Whereas process is the result of expertise and experience. The competitive advantage in desalination resides more and more in the water pre-treatment process (e.g. salinity, temperature) and not in the Reverse Osmosis filtration as it dramatically decreases the energy required.

Industrial outsourcing contracts benefit from cost cutting…

Industrial outsourcing contracts barely suffered from the crisis in 2009 since their business model is based on cost reductions. They are usually effective within the first year. Even though they represent a small portion of total water externalisation, industrial outsourcing contracts represent an important and increasing part of water operator revenues with attractive margins.

GRAPH 2: EVOLUTION OF INDUSTRIAL OUTSOURCING REVENUES OF VEOLIA ENVIRONNEMENT SINCE 2001 IN EUR MIOS



Source: Veolia Environnement

...and are getting more global

Within the same framework, industrials are widening the scope they are outsourcing to water operators. This can be explained by the industry's willingness to focus their efforts on their core business. Process and environmental issues are usually key in these projects and require very specific knowledge to carry them through to a successful outcome. Industrial outsourcing contracts increasingly combining broader outsourcing packages across different activities such as water treatment, water re-use and waste treatment. Veolia Environnement was, for instance, awarded the exploitation of the multi-utility power station (e.g. water cycle, waste treatment, compressed air, electricity, gas) of Vega do Sul, subsidy of Arcelor Mittal in Brazil for the next 14 years. The extension of scope included in outsourcing contracts is indeed very profitable and creates a financial and technical barrier to entry for smaller players.

PF(LUX)-Water

PF(LUX)-Water invests worldwide in companies that operate in the water industry. Launched in January 2000, the fund covers a market worth over USD 500 bn. Its growth prospects are very solid, with low accessibility for investors to tap into this asset class and a large number of under-researched stocks within the segment. Combining strong growth securities (water technology and environmental services) with more valuation-oriented securities (water utilities and packaged water), is, in our view, the best approach for striking a good balance between risk and potential reward.

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