QUILTER CHEVIOT

RESPONSIBLE INVESTMENT

Managing the rising risk around water scarcity

Across Quilter we have identified three thematic engagement priorities. This is part of our natural capital theme.

Natural capital can be defined as the stock of renewable and non-renewable natural resources (e.g. plants, animals, air, water, soils, minerals) that combine to yield a flow of benefits and ecosystem services to society[1].

SDG Alignment

> *"Every human should have the idea of taking care of the environment, of nature, of water. So using too much or wasting water should have some kind of feeling or sense of concern. Some sort of responsibility and with that, a sense of discipline."* Dalai Lama

Vital to all living organisms, water is a global issue, yet the risk around it – for investors at least – is regionally and sector specific. This can make disclosure and analysis of water risk at a company level difficult to measure and monitor. While we have heard anecdotal evidence of the private sector using water more efficiently, risks around this vital element – particularly its water scarcity – will be exacerbated by climate change, population growth and greater use that comes with growing prosperity.

1 Task-Force on Nature-related Financial Disclosures

Water risk in action: global business disruption

2022 marked the end of Chile's driest decade on record, which forced mining companies like Antofagasta and Anglo-American to reduce copper production.

Elsewhere, in August 2022, hydropower shortages caused by drought forced companies operating in south-western China such as Foxconn and Toyota to halt production.

In Mexico, politicians attempting to reduce strain on residential supplies are piling pressure on Heineken-owned breweries to relocate their water-intense practises from the north to the south of the country where the supply is more abundant[2].

Scarcity is not the only issue, however. Instances of contamination to domestic supply systems from chemicals, fertiliser run-off and release of microplastics are common. This can result in reputational damage and erosion of social license to operate, but also fines from regulators. Recent UK examples include a £90m charge to Southern Water in 2021[3] and a £1.5m fine for Dairy Crest in 2022[4] for harmful discharges into water systems.

Water risk and investment

Natural capital is one of the three thematic priorities across Quilter, and within this water is a key issue. Natural capital can be defined as the stock of renewable and non-renewable natural resources (e.g., plants, animals, air, water, soils, minerals) that combine to yield a flow of benefits and ecosystem services to society.[5]

Engagement

While water is vital to all industries, the risk it poses varies significantly across them. According to our research and analysis, based on the materiality of their exposure it, food, beverage and tobacco companies face the greatest potential impact, so our engagement programme focused there. We selected this industry group not only because of its significant direct water usage, but also its close links to the agricultural industry. Agriculture has the biggest water footprint of any sector, making it the world's largest driver by far of consumption, pollution, and other water-related impacts.[6]

Detailed data on corporate water usage are not systematically disclosed. The richest source of water information available to investors is produced by CDP, an NGO that collects data on disclosed usage. We used the CDP Water Scorecards (based on levels of disclosures and published policies) and reported annual water consumption to identify companies with the highest potential water risk.

This engagement programme was aimed at collating information, with the primary outcome to understand how investee companies are managing and potentially mitigating these risks. We also wanted to use the information gathered from these conversations to form an assessment of what best practice looks like.

Water risk engagement – target companies

KERRY, Associated British Foods plc, Mondelēz International, Coca-Cola

DIAGEO, Nestlé, PEPSICO, FEVER-TREE, Pernod Ricard

2 https://www.economist.com/business/2022/08/17/for-business-water-scarcity-is-where-climate-change-hits-home
3 https://www.gov.uk/government/news/record-90m-fine-for-southern-water-following-ea-prosecution
4 https://www.gov.uk/government/news/dairy-crest-given-record-fine-for-davidstow-environmental-offences
5 Task-Force on Nature-related Financial Disclosures: TNFD – Taskforce on Nature-related Financial Disclosures
6 https://www.cdp.net/en/investor/water-watch-cdp-water-impact-index

We were unable to engage directly with Coca-Cola Company and Nestlé.

Key findings from our conversations:

- **Our investee companies score well against external water benchmarks.** Based upon our engagement programme, most of our centrally monitored holdings in the food, beverage and tobacco industry group have a high level of disclosure and perform well against the CDP framework. The notable exception is AIM-listed Fever Tree, which is the only company in our target list that had not disclosed its water data to the CDP. Four out of nine of the companies engaged score A- or above according to CDP. However, there are clear leaders amongst this group as well as water risk management gaps.
- **Most companies do not place an internal price on water.** We found that water risk management is not as well established as climate risk management within most corporate environments. Several companies roll their water strategy into their climate risk strategy, and we regularly discovered companies describing investor and consumer interest in water as 'secondary'. Few companies with which engaged highlighted any experience of significant operational or supply chain disruptions related to water risks, and while many expect this to change in the future, few have explicit plans to move operations or switch suppliers. Pay-offs from improved performance came through enhanced community relations, local legal compliance and operational resilience, rather than the kinds of financial incentives we are beginning to see with decarbonisation strategies. It is also important to note that water stewardship also lacks global legal frameworks and benchmarks seen in efforts to combat climate change.
- **Best practice water stewards aim to be net positive water users.** In terms of benchmarking best practice, high performing companies (notably Diageo, Coca-Cola Company and PepsiCo) aim to be "net-positive" users in water stressed areas. They look to replenish more water than they use in operations by actively contributing to improving performance and resilience of the basin in which a facility is situated. Water risk is locally specific, but these measures could include restoring peatlands or replanting native forests to improve retention. This target is directly linked to participation in the Alliance for Water Stewardship[7] (a standard setting body) and uses a 'volumetric water' accounting standard to measure success. This is best practice and sets the benchmark for other companies.
- **Geospatial mapping is an important tool.** A common tool used by most companies with which we engaged is geospatial mapping to identify operations in water stressed areas. Again, most companies use the free-to-use World Resource Institute 'Aqueduct' tool8. This tool can be used to identify potentially water stressed operations and target them for additional analysis or support. More advanced companies, like Diageo, use these tools to begin to assess supply chains in stressed areas (where most water risk lies), but this work is nascent and often not accompanied by formal targets.
- **Collaboration on water basin management is essential.** As highlighted by the standards set by the Alliance for Water Stewardship, best practice frameworks involve industry and stakeholder collaboration. This also extends to regional actions. High performers demonstrated local and national government interaction to improve water basin performance. Working alone means that if other users are not demonstrating good stewardship this will nullify water risk mitigation efforts and can negatively impact facility performance.
- **Most water risk sits in supply chains which are less well managed.** Given this industry group's dependency on agricultural inputs, some 80-90% of water risk sits within its supply chains. Based on our engagement, this risk is not well managed. Advanced practitioners like Diageo and PepsiCo had programs in place to work with farmers to measure water practices where a direct relationship exists, either through contracts or operations through aggregators and cooperatives. This involved moving towards drip fed irrigation and complementary planting methods to retain soil moisture. Where commodity inputs were purchased through third parties, most companies admitted it was very difficult to have visibility on water risk. Where companies use contract manufacturers or franchise models, we saw some efforts to implement a base level of water practice, but this is often educational rather than likely to impact the renewal of partnership agreements. Outside of the advanced practitioners mentioned above, companies often focus on external manufacturers' water risk as a legal issue, concentrating on meeting minimum local legal requirements.

7 Home - Alliance for Water Stewardship (a4ws.org)

8 Aqueduct | World Resources Institute (wri.org)

Conclusion

Globally, areas of water stress are growing. From a top-down level, the starting point for monitoring water risk is understanding direct exposure to what may result in stressing this valuable and vital resource. Most of the companies with which we engaged have used geospatial mapping for several years to understand this exposure. Companies like Mondelez, Diageo and PepsiCo use this assessment to target capital expenditure on water efficiency, predominantly through wastewater use. More advanced practitioners are beginning to apply water stress analysis to suppliers and commodity inputs.

Most water risk sits in supply chains, and this is an area where all companies need to make progress. It is very much dependent on the business model, but we would welcome better cooperation with commodity input partners. Companies with more varied product ranges and greater use of third-party manufacturers struggled to demonstrate a significant degree of visibility or agency around supply chain water risk.

The best performing companies are often the most transparent and we are pleased to say that eight out the nine companies with which we engaged, report against the CDP water framework. A common factor among the companies with detailed water risk planning was membership of the Alliance for Water Stewardship. This is something we would encourage companies to join or align with. The organisation provides a framework that encourages companies to think about water risk at the catchment level. Its water replenishment target methodology – adopted by Diageo, PepsiCo, Coca-Cola Co. and Nestlé – commits companies to adding more water back to the basin than is used by operations. As mentioned above, this is achieved through a series of measures to improve catchment resilience. This encourages collaboration at a water basin level, which is an essential component of best practice.

Unlike more established engagement issues, where we have tracked progress over a number of years, this is the first time we have spoken specifically to investee companies in the food and beverage industry on water risk. Most companies admitted it is not a topic they discuss often with investors, but they recognise the risk is growing in importance. Two companies provided no response: Coca-Cola Company and Nestlé.

Our main aim from these conversations was to benchmark our companies and establish what good water risk management looks like. This is an important platform for future discussions on natural capital stewardship and we will continue monitor company progress against best practice expectations.

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QC00014 (11/2023)