

When it comes to the crunch...

With the world's financial markets reeling, and the global economy spluttering, fears are growing over the outlook for the environmental technology sector. But, argues Ian Simm, even a worldwide slump is unlikely to completely reverse its fortunes

Against a backdrop of the weakest financial conditions for almost 60 years, it's easy to forget that 2009 is shaping up as a crucial year for environmental policy. In the US, a new administration must decide if alternative energy, global warming and pollution control will feature prominently in its first 100-day agenda. In the EU, the finalisation of the 2020 climate and energy directives will test the resolve of law-makers to sustain aggressive, target-based policies to reduce emissions and boost renewable energy and energy efficiency. And, at the year end, international negotiators hope to achieve a breakthrough on a post-Kyoto agreement at the Copenhagen summit.

But, with a sustained credit crunch and economic slowdown, is the environmental sector on course for a difficult ride ahead?

To assess the sector's short- and medium-term future, it is worth looking at the likely outcomes of three different scenarios. First, we consider a mild downturn lasting 12-18 months, in which the credit crunch is promptly resolved by government action, economic confidence returns quickly and the market picks up more or less where it left off. In the second, a recession lasts for two to four years. Economies worldwide contract as consumers hold back expenditure and corporations halt investment, before a combination of successful economic policy and returning confidence turns the ship around. The third, most troubling, scenario involves a global slump lasting four years or more, where weak policy-makers consistently fail to find the levers to reverse the slowdown.

In the first scenario, most businesses in developed countries should be able to continue with their planned capital expenditure to meet environmental regulatory requirements. These might include retro-fitting end-of-pipe scrubbing equipment to remove polluting gases and particulates or introducing new information technology systems to track recycling rates. In anticipation that utility companies will roll-out smart meters in the next two to three years, the share prices of companies supplying meters have been doing well despite the stock market meltdown. For example, over the last twelve months to the start of September, US-based Itron has risen by 22%.

Meanwhile, OECD governments are likely to continue developing new regulatory programmes, thereby providing good market visibility for the suppliers of environmental goods and services. In this scenario, individual US states are likely to follow through with Renewables Portfolio Standards (which oblige electricity retailers to source a portion of their supply from renewable power generators). Such standards are important drivers of the expanding marketplace for renewable power, supporting the long-term growth of the industry.

Also, multinationals are likely to lobby hard for long-term clarity on environmental goals, particularly regarding carbon emissions trading after 2012. Most would prefer binding international agreements to the procrastination that has dogged carbon markets thus far.

However, in developing countries, it is likely that businesses will lobby governments to delay the enforcement of regulatory targets or consider exemptions for struggling companies. Even in the case of a mild downturn, funds may dry up in the developing world as investors seek safer havens. Capital expenditure in critical sectors like water treatment may be impacted to a lesser degree, and the share prices of companies geared to public sector expenditure, such as Singapore-based Hyflux, should out-perform on a relative basis.

In the case of a two- to four-year recession, businesses in developed countries are more likely to lobby for delays to or exemption from environmental regulations. Governments may well capitulate, as voters respond to policies which save jobs rather than regulations designed to improve the environment.

Initiatives that could be postponed include extension to the European waste management regulations and the further roll out of US tax credits to support renewables. In a severe recession, European utilities could also lobby for more time to comply with the Large Combustion Plant Directive, which limits the operations of all but the least polluting coal-fired power stations.

Multinationals, concerned about collapsing markets and dwindling profits, may be more inclined to withhold support for clear, long-term targets on policies such as carbon emissions, hoping that the finalisation of tough targets binding all industry participants can be delayed until the economy has turned around.

The developing world would see an even greater impact, as domestic markets contract severely. On the one hand, some formerly acute environmental problems would become less severe as pollution loads drop. However, severe local environmental problems such as drought and floods may strengthen the resolve of politicians in affected countries to ensure that regulations are enforced. Even in these apparently dire circumstances, flood and storm water management groups could benefit; the share price of AIM-listed Hydro International has risen by more than 29% over the past twelve months and looks set to enjoy further gains irrespective of the economic weather.

At the time of writing, the third option of a global slump seems unlikely. If it were to happen, we would be in very much uncharted waters. When the world economy last collapsed, in 1929, the environmental sector did not exist. Beyond water treatment, there was virtually no environmental policy. Carbon footprints were simply what the chimney sweep left behind.[nice!]

In this scenario, it is easy to argue that all bets are off, and that the environment would disappear from the agenda. However, with industry and commerce readily adopting energy and resource efficiency measures and underlying long-term global regulatory frameworks unlikely to be repealed, even in a worst-case scenario, the drivers of environmental market activity should continue at pace.