WATER TECH INVESTMENT

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Water tech enjoys sustained investment, despite valuation adjustments

Investors in early-stage water technology companies are welcoming more measured valuations as financial flows into the sector remain robust. Senior technology analyst Yujia Shen engages with a cohort of early-stage investors to investigate the key trends.

Despite a general decline in funding volumes flowing to start-ups since the middle of 2022, financial backing for water technology companies has displayed exceptional resilience, due in part to a growing perception of the sector's critical role in the climate agenda.

Equity investment in water tech start-ups has exhibited consistent growth in recent years, escalating from $365 million in 2020 to more than $690 million in 2022. The first nine months of 2023 alone have seen well over $600 million raised, according to GWI WaterData.

WATER TECH FUNDING

Growth equity investment in 2023 is approaching the dizzy heights that 2022 saw.
Source: GWI WaterData
** YTD*

This steadfast growth is especially noteworthy, considering the 33% decline in the amount of money flowing to start-ups globally in 2022 compared to 2021 which, according to The Economist, is down to rising inflation, increased interest rates, and weak stock market performance.

One contributing factor to this contraction is the increasing alignment of investors' portfolios with strategic government objectives and public funding guidelines amid an economic downturn. Initiatives like the

United States' Inflation Reduction Act and the European Union's Net Zero Industry Act, which are set to direct substantial public subsidies towards the clean tech sector, are heightening investor enthusiasm for climate-friendly technologies.
The significant surge in interest in water technology is also being driven by a heightened awareness of the impact of climate change on water-related challenges. Overall, there is a greater emphasis on discussing water within the context of climate considerations, not only in the fundraising arena, but also in the propositions put forward by start-ups.

While investment in the water tech domain remains robust, valuations have experienced a long overdue downward adjustment. Across all sectors, private start-up valuations witnessed a 56% decline from Q4 2021 to the corresponding period in 2022, according to The Economist.

Investors in the water sector view the adjustment as a positive recalibration, moving away from inflated valuations towards more prudent and rational investment approaches that prioritise current revenue over future projections. "We're seeing valuations come down – they're far more realistic," summarised Water Foundry Ventures founder and general partner Will Sarni.

Alex Crowell, a partner at PureTerra Ventures, echoed this sentiment, affirming that recent economic shifts have brought about a much-needed reality check, prompting a return to more measured and rational valuations. "When we invest in companies, we like to make them further investible. If a company comes out with an extremely high valuation – warranted or not – they're hurting themselves on the back side," he commented to GWI.

The flip side of this is that it has made exits more challenging. "It's harder to sell a company at a strong and reasonable valuation right now, because most strategic and financial buyers are hesitant due to concerns about what the future holds for the world economy," observed Brian Iversen at Cimbria Capital. "I have in certain cases felt forced to raise additional growth capital, rather than selling."

Tom Ferguson, the founder of Burnt Island Ventures, also highlighted the need to navigate exit strategies with care, and cautioned against selling a company prematurely or in unfavourable market conditions. "In venture, our compensation is determined not by internal rate of return (IRR), but rather by multiples: net cash on cash returns." He further emphasised that while it is crucial to contemplate exit strategies early on, the key to a successful exit strategy lies in having the flexibility to choose the right moment for an exit. The focus therefore has to be on

building solid businesses with strong financials, with the ability to address real pain points, and the capacity to withstand market uncertainties.
Despite the changing dynamics around valuations, fundraising in the sector remains resilient. "I am seeing funds take longer to raise capital. I'm seeing fewer emerging managers get funded. But I'm still seeing very strong fundraising for the climate and sustainability sector – including water," observed Ginger Rothrock, senior director at HG Ventures, the corporate venture capital arm of The Heritage Group.

"In general, the water sector has been insulated – we were insulated on the upside, and so we're relatively insulated on the downside as well," Ferguson noted. "This is not a friendly fundraising environment, but we haven't seen anybody not able to raise that deserves to."

Re-framing the challenge may also help to attract capital into the sector. Emerald Technology Ventures announced last month that its industrial climate tech fund had exceeded €250 million ($264 million), while Mazarine Ventures secured $25 million of capital to invest in climate adaptation technology earlier this year. Their success lies in positioning technologies that mitigate water-related risks as solutions which address public health concerns and climate change impacts, in the hope that that will encourage a wider pool of investors to open their wallets.

Getting the focus right

WHERE IS THE GROWTH EQUITY GOING?

Over 10% of the deal number in 2023 so far has involved PFAS treatment companies as the mania around the pollutants peaks. Innovations involving digital and desalination can still be highly attractive.
Source: GWI WaterData
** Includes atmospheric water generation*

From a market adoption perspective, utilities are placing a growing emphasis on optimising returns from digital investments, especially in light of an economic slowdown and an ongoing cost-of-living crisis. This shift in focus has prompted investors to redirect their interest from consumer-facing applications towards solutions that boost operational efficiencies and address pain points that were previously challenging to tackle. Moreover, rising concerns over water scarcity are propelling interest for smart irrigation technologies.

While investors acknowledge the market potential to detect, remove, and destroy per- and polyfluoroalkyl substances (PFAS), the hype has

been somewhat checked by a mismatch between the developmental stages of technologies and investor interest.
In PFAS removal, a number of effective removal strategies involve relatively low-grade (and in some cases commercially proven) technologies, and no single solution has yet emerged as a differentiated market leader which would naturally attract smart growth capital.

In PFAS detection and destruction, meanwhile, a notable technology gap persists, especially for faster and more cost-effective detection solutions, and for destruction methods that prevent shifting the problem downstream. Many of these are still in the experimental stage, lacking visible practical applications, which makes investors hesitant to commit due to the associated high risks. Additionally, destruction currently costs an order of magnitude more than removal, limiting end-client demand in jurisdictions where the regulations do not mandate destruction.

Despite these challenges, Ferguson acknowledged that “PFAS destruction is really important and it’s going to be a big pain point for a lot of people.” Burnt Island led a seed round in PFAS destruction start-up Aclarity last year, and the company is currently on the verge of securing its first commercial sale at scale.

Individual funding rounds in the PFAS sector are often substantial: PFAS detection and bioremediation start-up Allonnia secured $30 million of funding in July, Aclarity raised $12.8 million, also in July, while last month, Puraffinity raised $13.9 million in a Series A funding round.

The encouraging rise of specialised water investors in recent years signals a profound understanding of the unique dynamics of the water sector. As Crowell summarised, “money for capital, although important, is only a small portion of what this industry requires. It requires smart capital.”