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Industry: **WATER INFRASTRUCTURE**

Coverage:

Ticker	Rating	Price
AWK	BUY	\$25.40
AWR	NEUTRAL	\$34.30
CWT	NEUTRAL	\$37.19
PNR	BUY	\$36.56
WTR	NEUTRAL	\$22.62
WTS	NEUTRAL	\$37.00

The Water Rundown

PNR Offers FY11 Guidance

End Market and Industry Updates

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- Copper Prices Reach Record Level

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- VE Renews North American Contract
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- VE Announces Construction Project

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IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.

**PNR OFFERS FY11 GUIDANCE**

Pentair (PNR, BUY, \$39 PT) recently offered its FY11 guidance. The company expects FY11 sales growth in the mid-single digit range to \$3.2B. The company's forecast implies high-single digit organic revenue growth, which is offset by the negative y/y impact from the rolling-off of the Gulf Intercoastal Waterway (GIWW) project which will negatively impact FY11 sales by ~\$56M. The company expects FY11 EPS of \$2.20 to \$2.35 and is generally in line with consensus of \$2.31 and our \$2.28 FY11E EPS forecast. The company also reiterated its 4Q10 guidance of \$0.42-0.47 and FY10 guidance of \$1.93-1.98 on sales of \$3B. We are not changing out estimates at this time as our 4Q10E and FY11E EPS estimates of \$0.45 and \$2.28 are within management's guidance range, which we believe to be achievable given current market conditions.

Revenue growth from volume improvement and pricing. Management expects overall revenues to increase in the mid-single digits in FY11 to ~\$3.2B (+\$200M), driven by 7-8% y/y organic revenue growth in its Technical Products segment and 4-6% y/y organic revenue growth in its Water segment. We note that excluding the impacts of the GIWW project rolling off, recurring revenues would have increased 7-9% y/y. Overall, volume (+\$170M) and pricing (+\$50M) are expected to offset the negative impact from the rolling-off of the GIWW project (\$56M) and FX headwinds (\$10M). More broadly, the company expects that 2/3rd of volume improvement will come from new product offerings and expanding global penetration and distribution, while the remaining 1/3rd will be driven largely by market growth and end market recovery. Geographically, the company expects low single digit growth in the U.S. and Europe, with Fast Growth markets up double digits. We note that PNR's European exposure is predominantly located in healthier markets, including Germany, France and the Benelux countries.

In regard to the companies end markets, management expects the industrial end market (~40% of sales) to expand 10% in FY11, particularly due to continued strength in capital and maintenance expenditures and further channel development. U.S. Residential (~29%) is expected to grow in the mid-to-high single digits through new products and pricing actions, while non-U.S. residential (~10%) is expected to expand by double-digits in fast growth markets. We note that ~80% of the company's residential business is related to R&R and maintenance, rather than new construction. Management expects mid-single digit growth in the commercial end market (~11%) due to strength in food services, fire, HVAC and Technical products. Meanwhile, mixed performance is expected in the infrastructure market (10%), with a choppy U.S. municipal market being offset by strong international sales related to various desalination projects.

Pricing to offset raw material cost inflation, prebuying limited. Management announced that it has implemented a number of pricing initiatives for 1Q11, specifically scheduled for Jan 1 and Apr 1, which should result in 1.5% (\$50M) in additional revenues when it's all said and done. As a reminder, the company was not successful in realizing price increases in FY10 in an attempt to maintain market share. Indeed, while the company's 1.5% increase is approximately 50bps less than it would realize in a more normalized market environment, management believes the proposed increase will be sufficient to offset rising raw material costs it's seeing in motors (\$170M in purchased materials annually), steel (\$60M) and resins (\$75M). Despite the company's pricing initiatives, however, management noted that it has seen only modest prebuying ahead of the price increase, largely due to the composition of its distribution network, despite what it believes to be thin channel inventories in its water segment. Indeed, most distributors stocking water-related products are smaller independents which continue to view business cautiously. Likewise, technical products distributors do not appear to be stocking up ahead of the price increase, due in large part because inventories in that channel appear to be healthier than those in the water products channel due to a stronger 2H10.

EPS growth to come from 30% incremental margins. The company expects EPS growth to come from 30% conversion of volume growth, or a 100bps y/y improvement (\$50M). That said, the company's implied incremental margin is ~500bps below its long-run target of 35%. Management also expects a 100bps (\$35M) benefit from net price, mix, productivity and inflation, which will offset a (30bps) impact from GIWW/pension costs and a (60bps) impact from operating expenses. As a result of the aforementioned drivers, operating margins are expected to expand 100bps to 12% due to operating leverage on the company's existing manufacturing base. The main downside at this point could come from raw material inflation in which copper and steel are important components.

Dividends, organic growth, and M&A highlighted as uses of cash. Management expects to generate ~\$240M in FCF in FY11, with net income conversion of ~110%. Capital allocation remains skewed to continued dividend distribution and organic growth initiatives, rather than sizeable acquisitions or sizable share repurchase programs. Management expects to return \$100M to shareholders in FY11 through dividends (\$70M) and share buybacks (\$30M). Share repurchases will be limited to offsetting dilution of existing shareholders. See *PNR: Offers In-line FY11 Guidance, Maintain BUY*, December 20, 2010 for a longer review.



END MARKET & INDUSTRY UPDATES

Build America Bonds End - The Build America Bonds program, a hugely popular Recovery Act initiative that allowed many state and municipal agencies to support infrastructure projects, including water and wastewater system upgrades, is coming to an end on December 31. Nearly \$180 billion in debt has been issued under the program since its inception in April 2009, according to Thomson Reuters. The Obama administration created the program last year to help state and local agencies regain access to the bond markets after the financial crisis made it tough for them to borrow. Under the Build America Bonds program, the agencies issue taxable bonds with the federal government subsidizing 35% of the interest payments. The money has been used not only to rebuild highways, but also up upgrade the nation's deteriorating water infrastructure network of aging pipes and treatment/distribution facilities. Agencies within California were the top issuers of Build America Bonds, with \$38.4 billion in offerings. The state alone issued about \$14 billion, according to the Treasurer's Office. It saved well over \$1 billion over the life of the bonds. Agency officials say they are not quite sure what to expect in 2011 when they are forced to rely only on the tax-exempt bond market. Agencies nationwide may not turn to the bond market as often next year.

Source: CNNMoney.com

Copper Prices Reach Record Level – Copper prices climbed to record levels after China recently raised interest rates to counter rising inflation, suggesting that the government may refrain from further tightening in the coming weeks. Copper prices continue to face upward pressure as global supply is expected to fall short of demand and as China's fiscal policy moves suggest that it will continue to implement a number of large infrastructure projects. China is the world's largest buyer of copper. Copper stockpiles in Shanghai, China fell 5.8% last week to 120,426 tons, marking the fourth week of declines. Meanwhile, demand is expected to outstrip supply next year due to a number of mine disruptions globally.

Source: Bloomberg

LBR Note: We uncovered in our recent WTS survey that the company announced price increases of 6-10%, effective January 3, in order to help offset rising raw material costs. 74% of our contacts expect the price increase to hold in full, with a further 21% expecting the price increase to hold at least in part. Contacts also noted that most competing manufacturers have announced increases of a similar magnitude.

WATER UTILITIES UPDATES

Aqua America Announces Acquisition – WTR (N) announced that it has purchased water and wastewater systems in Texas and North Carolina. The company's Texas subsidiary acquired two systems in Henderson County, Texas for \$874K, while the company's North Carolina subsidiary acquired a wastewater system in Carteret County for \$900K. The Texas acquisition is considered a "tuck-in" as it serves some 1,150 people near the company's existing operations in northeast Texas. The company's acquisition in Texas further points to its interest in expanding its presence in fast growth markets. Reflective of this strategy, eight of the company's acquisitions in FY10 have been in Texas, where the company has realized 2% customer growth through 3Q10, two thirds of which has come from acquisitions. We believe the acquisition will allow WTR to realize maximum economies of scale in Texas, while further streamlining its rate case filing procedures. The North Carolina acquisition included approximately 60 residents and a shopping center. We note that WTR acquired two water systems and one wastewater system in North Carolina this year.

WATER INFRASTRUCTURE UPDATES

PNR expands into Brazil through Acquisition – PNR announced that it will acquire Hidro Filtros do Brasil, a manufacturer of water filters and filtering elements for residential, commercial and industrial applications in Brazil and its neighboring countries. The acquisition will be positioned within the Pentair Residential Filtration brand and should double the company's market share in the Brazil, which is presently in the low single digits. The company employs ~140 people and had sales of more than \$12M in the LTM. Management announced during the call that it paid \$10M for the business and expects the transaction to close in the beginning of 2011. Hidro Filtros' headquarters and manufacturing facility is located in Caxias do Sul, in the state of Rio Grande do Sul. In regard to the broader M&A environment, management noted that it has become more active in the last six months in pursuing potential M&A candidates and expects to return to its normal pace of acquisitions, presuming suitable candidates arise, in the coming quarters.



Veolia Water Renews North American Contract – VE (NR) announced that it has reached a five-year agreement with the International Boundary & Water Commission (IBWC) to continue operations that address a number of sanitation needs on the Tijuana/San Diego border. The contract is valued at \$35.5M and includes managing, operating and maintaining an existing wastewater treatment facility, as well as the startup and long-term operation of a secondary treatment facility. VE has been IBWC's only contractor of record since the system began operating in 1996.

Quebec Enters the UK Water Market – Canada's Caisse de Dépôt (CDPQ), a pension fund manager, announced that it has taken a 50% stake in the South East Water Company for \$255.2M. The transaction marks the entry of a major new Canadian investment fund into the regulated UK water sector. As part of the transaction CDPQ will buy out Hastings, an Australian firm, entire 38.7% interest in the utility, while also reducing Utilities Trust of Australia's holding from 61.3% to 50.0%.

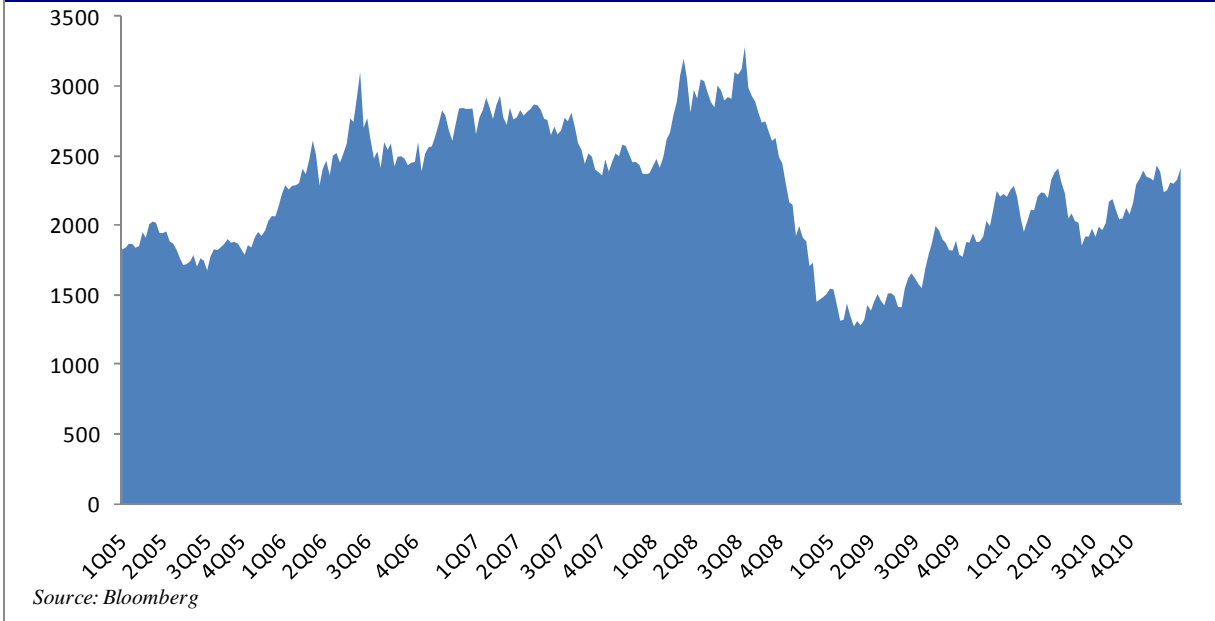
Itron and Silver Springs Networks Expand Agreement – ITRI (NR) announced that it has finalized and expanded its agreement with Silver Spring Networks (private) to integrate ITRI's electric meters and gas modules with Silver Spring's Smart Energy Platform. Under the terms of the deal the companies will deliver a multi-vendor advanced metering solution for gas, water and electricity providers. Orders will be accepted soon for delivery in mid-2011.

Calgon Carbon Settles Dispute with ADA – CCC (NR), a maker of air and water purification products, announced that it has agreed to pay \$7.2M to settle a dispute with ADA Environmental Solutions over sales commissions. A jury previously awarded ADA a \$12M verdict stemming from selling CCC's products to coal-fired power plants.

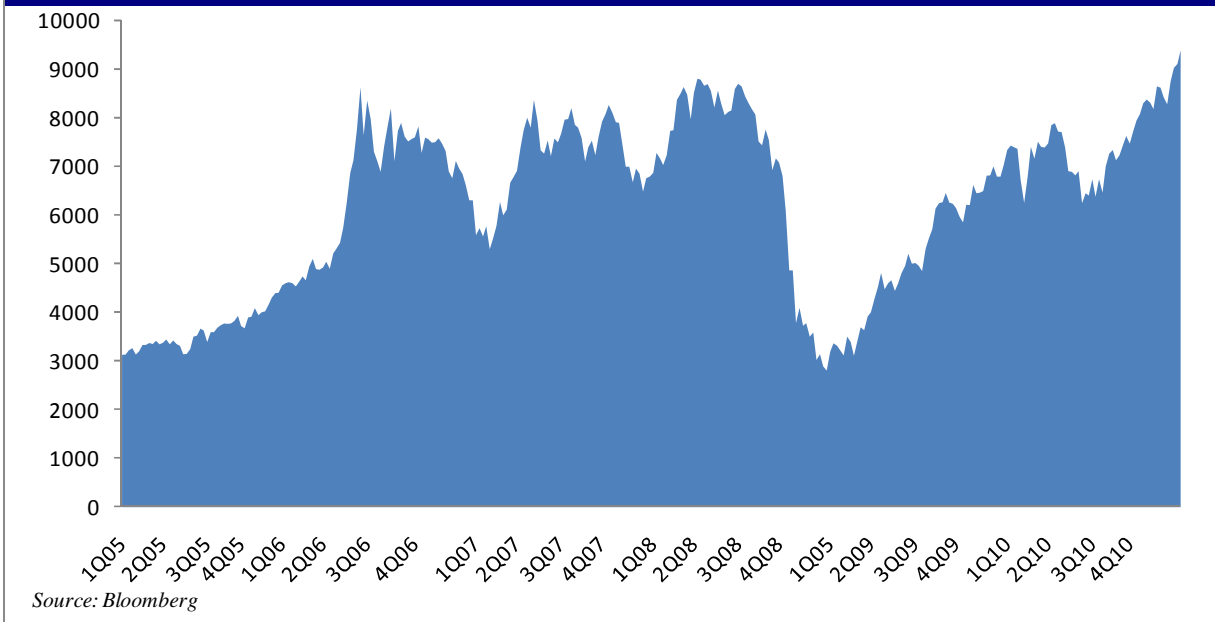
Veolia Water Announces Construction Project – VE (NR) recently announced the construction of its first landfill gas-to-energy project (LFGTE) in the United States. The project, which is scheduled to begin in mid-2011, will have the initial capacity to generate 42,000 megawatt hours (MWh) of electricity annually, or enough to power some 2,800 homes. In conjunction with the construction of the plant, VE has entered into a power purchase agreement with Wisconsin Public Service (WPS), the chief electricity and gas provider for residential customers in northeastern Wisconsin. WPS will purchase all of the power generated by the plant once it's completed.



Spot Aluminum Price (\$ per metric ton)



Spot Copper Price (\$ per metric ton)



WATER INDUSTRY PEER VALUATION

(\$ in millions, except per share data)

Company	Ticker	FY End	Rating	Target	% Upside	Share Price	52 Week		Mkt Cap	Revenue Last	Last FY	Earnings per Share		P/E		Dividend Rate	Price/Book
							Hi	Lo				Current FY	Next FY	Current FY	Next FY		
U.S. WATER UTILITIES																	
AMER STATES WATER	AWR	Dec.	Neutral			\$34.30	\$39.61	\$31.20	\$ 639	\$ 361	1.62	1.78	2.15	19.3x	16.0x	3.0%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	14%	\$25.40	\$25.70	\$19.41	\$ 4,442	\$ 2,841	1.25	1.55	1.70	16.4x	14.9x	3.5%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$22.62	\$22.50	\$16.45	\$ 3,111	\$ 671	0.77	0.92	1.00	24.5x	22.7x	2.7%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$37.19	\$39.70	\$33.81	\$ 775	\$ 449	1.95	1.91	2.20	19.5x	16.9x	3.2%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$18.99	\$19.59	\$16.43	\$ 143	\$ 61	0.97	1.02	1.11	18.6x	17.1x	4.0%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$27.03	\$27.82	\$20.00	\$ 234	\$ 59	1.19	1.2	1.19	22.5x	22.7x	3.4%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$18.69	\$19.31	\$14.74	\$ 291	\$ 91	0.72	0.94	0.95	19.9x	19.7x	3.9%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$27.40	\$28.39	\$19.00	\$ 128	\$ 33	0.55	0.84	0.95	32.6x	28.8x	2.7%	1.8x
SIW	SIW	Dec.	NR			\$26.58	\$28.24	\$21.60	\$ 493	\$ 216	0.81	0.98	1.06	27.1x	25.1x	2.6%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$17.31	\$18.00	\$12.83	\$ 219	\$ 37	0.64	0.71	0.76	24.4x	22.8x	3.0%	2.1x
Average														22.5x	20.7x	3.2%	1.7x
EQUIPMENT/ FILTRATION/ TREATMENT SECTOR																	
PENTAIR	PNR	Dec.	BUY	\$39	7%	\$36.56	\$39.32	\$29.41	\$ 3,608	\$ 2,692	1.47	1.96	2.28	18.6x	16.0x	2.1%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$37.00	\$37.00	\$27.51	\$ 1,370	\$ 1,234	1.54	1.92	2.23	19.3x	16.6x	1.2%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$75.06	\$85.25	\$55.42	\$ 694	\$ 547	3.05	2.90	3.84	25.9x	19.5x	1.6%	1.1x
BADGER METER	BMI	Dec.	NR			\$43.74	\$45.15	\$32.58	\$ 658	\$ 250	1.80	1.91	2.08	22.9x	21.0x	1.3%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$15.47	\$18.35	\$11.75	\$ 871	\$ 412	0.69	0.68	0.86	22.8x	18.0x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.65	\$7.28	\$3.08	\$ 191	\$ 47	0.07	(0.08)	-	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$41.15	\$41.79	\$24.93	\$ 956	\$ 626	1.29	1.86	2.26	22.1x	18.2x	1.3%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$36.15	\$37.40	\$22.81	\$ 607	\$ 266	1.15	1.34	1.6	27.0x	22.6x	1.2%	2.6x
ITRON	ITRI	Dec.	NR			\$54.73	\$81.95	\$52.03	\$ 2,211	\$ 1,687	2.09	4.02	4.33	13.6x	12.6x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$35.27	\$36.92	\$22.97	\$ 690	\$ 866	0.81	1.42	1.67	24.8x	21.1x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$4.42	\$5.99	\$2.21	\$ 685	\$ 1,338	-0.29	(0.17)	0.15	NM	NM	1.6%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$23.78	\$31.46	\$14.62	\$ 221	\$ 283	-0.26	0.12	0.73	198.2x	32.6x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$49.87	\$51.01	\$31.84	\$ 5,744	\$ 2,402	1.77	2.50	2.5	19.9x	19.9x	1.3%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$38.87	\$45.80	\$27.39	\$ 1,781	\$ 1,991	1.90	2.70	2.91	14.4x	13.4x	1.4%	1.7x
Average														45.7x	20.1x	0.8%	2.0x
WATER RESOURCES/ INFRASTRUCTURE																	
INSITUFORM TECH	INSU	Dec.	NR			\$26.93	\$28.52	\$18.52	\$ 1,056	\$ 727	1.04	1.52	1.78	17.7x	15.2x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$61.82	\$72.80	\$30.80	\$ 774	\$ 358	1.11	1.68	2.21	33.8x	28.5x	0.6%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$26.58	\$28.18	\$18.00	\$ 1,642	\$ 2,201	1.22	1.25	1.43	21.8x	19.3x	0.0%	1.7x
Average														25.6x	19.4x	0.7%	2.1x
Relevant Indices						Share Price											
Dow Jones Industrials		DJ30				\$11,573											
S&P 500		SPX				\$1,257											
Nasdaq Composite		NDX				\$2,230											

Source: Baseline; Company reports and LBR Estimates. EPS reflects diluted EPS, excluding extraordinary items. Numbers in italics reflect consensus estimates.

** Time period for annual estimates may vary based on reporting date.

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APPENDIX

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Neutral	145	62.8%
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period.

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