Industry Update

LONGBOW Research
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February 22, 2011

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Industry: **WATER INFRASTRUCTURE**

Coverage:

Ticker	Rating	Price
AWK	BUY	$27.00
AWR	NEUTRAL	$33.46
CWT	NEUTRAL	$36.10
PNR	BUY	$38.17
WTR	NEUTRAL	$23.44
WTS	NEUTRAL	$40.11

The Water Rundown

AWK Investor Conference Recap

Water Infrastructure Updates

- ITRI Reports Earnings; Forecast Misses Estimates

End Market and Industry Updates

- Obama's FY12 Budget Request Cuts Water Grants
- Flood of Money Needed to Fix China's Water Woes

Industry Data and Graphs

- DWSRF - Annual Federal Funding
- CWSRF - Annual Federal Funding

IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.

AWK INVESTOR CONFERENCE RECAP

We attended AWK's investor conference on February 15th in New York City. This was the company's second such conference following its complete divestiture by RWE and it was Jeff Sterba's first since he replaced Donald Correll as President and CEO. A preliminary view of the company's 4Q10 earnings were released in conjunction with the presentation. During the various presentations, management discussed its (I) longer term growth strategy, (II) Homeowner Services & Military Contract operations, (III) recent divestitures and its M&A outlook, and (IV) its current financial position and the progress it has made in reducing its ROE gap (actual vs. allowed ROE). Overall, despite missing our 4Q10 earnings forecast due to below gross profit line items and the company's position as a net seller of assets in FY10 (mostly underperformers), we continue to believe that the company is taking the necessary steps to reduce its ROE gap and we remain encouraged by the longer-term growth prospects of the company, be it through acquisitions or a greater focus on its non-regulated businesses. We offer a number of key takeaways from yesterday's investor conference below:

Preliminary 4Q10 Results

At yesterday's investor conference, AWK preannounced 4Q10E of $0.23 which came in below our $0.27 view and the Street's forecast of $0.24. The company is expected to formally announce earnings on February 25th. Revenue of $664M is ahead of our $655M expectation, but gross margin came in 50bp below our view. While consumption was up 2% for the year, the company's gross profit of $152M during the quarter was just $1M below out view, suggesting the entire 4Q miss came from below the gross profit line. AWK's efficiency ratio of 46.2% for FY10 was a 230bp improvement from the prior year, while we were looking for a 180bp improvement. In regard to its efficiency ratio, the company offered a five-year target of sub-40% at its investor conference. In addition, the company has $93M in rate cases it hopes to resolve by the end of FY11. As a reminder, we reduced our 4Q10E to $0.23 to be in compliance with guidance, but made no changes to our $1.72 FY11E estimate, pending further visibility to cost controls and non-operating items which should be made clearer when the company officially reports its 4Q10 results.

FY11 Guidance and Long-Term Growth Prospects

AWK offered FY11E guidance of $1.65-1.75, though management noted this was a working number as it is heavily dependent upon consumption trends in FY11 and, to a lesser degree, input costs like fuel & power ($100M annually) and chemicals ($53M annually). Nevertheless, company guidance is above the Street's view of $1.65, and the stock was up on the news yesterday. Our FY11E EPS forecast of $1.72 is within management's guidance. In regard to the company's guidance, management noted that just a 1% change in consumption would impact EPS by $0.02/share, thereby reducing FY11 EPS to $1.63 on the low end or $1.77 on the high end. To reach the high end of the range, management noted that its O&M expense and interest rates would need to decline 1%, while Fuel & Power and Chemical costs would need to decline 10%.

Management also reiterated its 7-10% long term EPS growth goal and offered additional color as to how it expects to reach that target. In the near term (1-2 years), management noted that ROE improvement and regulated investments would be the key driver of earnings growth, while in the longer term (3-5 years), new service offerings (Homeowner Services & Military Contract operations) and acquisitions would drive EPS acceleration. Operational excellence/efficiencies related to the company's $280M multi-year investment in technological improvements are also expected to improve profitability but we are naturally concerned about potential hiccups in implementation that can't be adequately predicted. Finally, management noted that for every $1 it saves in O&M expenses, it is able to parlay that amount its $6 of invested capital, for which it can earn $0.30/share annually.

Military Base Operations

Unlike American States Water (AWR, N), AWK does not disclose the financial results of its military base operations. That being said, management offered additional data on the segments performance in recent years, which leads us to believe that the company has been more successful than AWR in this line of work. Indeed, since 2002, a total of 23 major water/wastewater contracts have been awarded, with AWK securing a total of 10 in that time. Furthermore, AWK has been awarded all of the four major contracts that have been issued since 2008, which represents ~$2B in backlogged work. As a result, we believe the company is in a strong position to secure the 50 major water/wastewater contracts that are expected to be awarded in the next five years. Management noted that the estimated value of these contracts totals $11B and that it intends to actively pursue these project lettings as they arise. We note that such contracts are generally 50 years in length and include intermittent price redeterminations which allow the company to adjust the cost of services provided based on a number of performance targets.

Municipal Contract Operations

A key tenant to the company's longer-term growth prospects is a greater focus on the operation of municipal water/wastewater systems in those instances where the municipality chooses to maintain ownership of its assets. Management expressed its frustration with its current business model that involves short-term contracts whereby the company, in its view, takes on excessive risk for relatively low margins. As a result, management is in the process of adjusting its current business model and hopes to secure longer term contacts in the form of public-private partnerships (P3s), whereby risks would be shared by both parties, and price redeterminiations would be awarded to the company when certain performance targets were met. Management noted during the presentation that it is currently in negotiations with a large municipality whereby the company would employ its revised contract operations framework, though no additional information was provided.

Regulatory Initiatives

Given its broad operating footprint, management noted that it is holding open discussions with various state Public Utilities Commissioners in order to promote more constructive regulatory framework, so that the company may earn an appropriate rate of return on the investments that it makes. Specifically, management is pushing state PUC's to implement Distribution Infrastructure Service Charges (DISC) which would allow the company to recover the cost of infrastructure investments almost immediately, rather than having to go through the time consuming rate case cycle. We note that six of the company's markets already offer a DISC program, including the company's second largest market, Pennsylvania. However, New Jersey, the company's largest market, does not offer such a program. Furthermore, to combat the negative earnings impact resulting from the continued decline in customer water usage (0.6-1.6% annually), the company is lobbying state PUC's to implement decoupling mechanisms, which would essentially reduce the variability in the company's revenue stream caused by inconsistency in water consumption due to weather or conservation.

ROE Gap

Management remains steadfast in its goal of reducing the current ROE gap, or the difference between allowed and earned ROE, in the coming quarters. The company's realized ROE in FY10 was 6.49%, a 121bp improvement from the comparable period last year, compared to the allowed ROE of 10-10.5%. Management expects ROE of 6.8-7.2% in FY11, up 30-70bp from the prior year. We note that it will be difficult for the company to reduce 1.25% of the total gap, which represents parent company debt from the RWE divestiture, in that it is unable to recover the cost of this debt through rate increases. As a result, the narrowing of the spread will have to come largely from rate case catch-up. With $92M in pending rate cases which are expected to settle in FY11, the company is on its way to fill the gap in the coming years.

Capex and Debt Maturities

Management continues to expect to spend $800M to $1B on capex annually for the foreseeable future, with the majority of the funds being diverted to those markets where regulatory lag is relatively short so that the company can recover its investments in a timelier manner. Management broke out its two year capex plan by asset type, with distribution (38%), customer water meters (15%), treatment (9%) and water mains (7%) accounting for the largest portion of the company's intended spending plan. Management noted that cash flow from operations continues to improve relative to capex, suggesting that there is no anticipated need for an equity offering in FY11. Lastly, management noted that just 4% of its total outstanding debt of $5.397B needs to be refinanced within the next four years.

Acquisition Outlook and Portfolio Optimization

AWK has been a net seller of assets in FY10 in an attempt to rightsize its portfolio by exiting markets where the company is unable to reach critical mass and benefit from economies of scale. Indeed, the company recently sold its operations in AZ and NM to EPCOR for $470M, the proceeds of which were used to pay down debt. AWK also recently swapped assets with WTR, whereby the company sold its assets in TX, but acquired 59 wastewater systems in Missouri for $3M. That being said, the rate of deals for AWK has lagged its principal peer, WTR (N), which has been quite active on the acquisition front in 2010. While management noted it is in discussions with a number of potential sellers, it admitted that most were smaller tuck-in acquisitions that would complement its existing operations in a number of geographies. While we are discouraged by the pace of acquisitions, we believe the company's heightened interest in expanding its services to homeowners, municipalities (P3s) and the military, as discussed above, should offer a number of avenues for revenue growth going forward. For more on AWK's investor day, see *AWK: Highlights from Investor Day in NYC* published February 16, 2011.

WATER INFRASTRUCTURE UPDATES

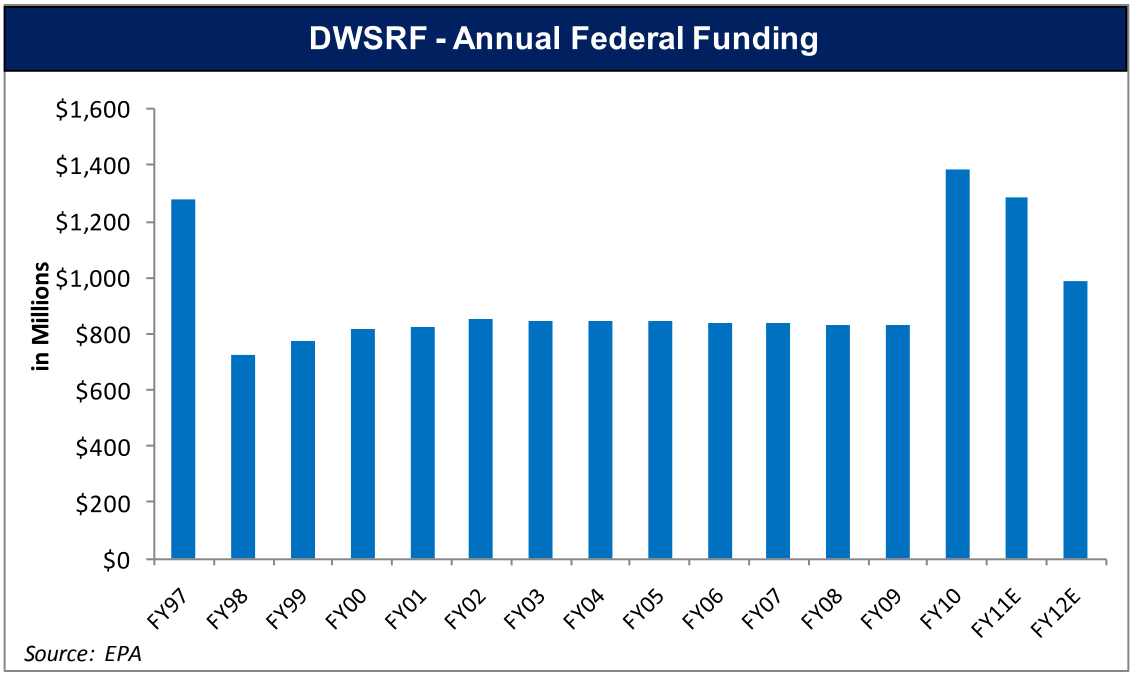
Itron Reports Earnings; Forecast Misses Estimates – ITRI, a manufacturer of utility meters, communications equipment and electricity-management software, reported (2/17/2011) 4Q10 and FY10 EPS of $0.05 and $2.56, respectively, on revenues of $621M and $2.26B, respectively. Revenues during the quarter surged 30% y/y and 34% during the year. The increase in revenues was primarily driven by higher shipments of smart meters and modules in North America. Gross margins of 29.9% during the quarter declined 60bp from the year ago period. North American margins declined 130bp y/y due to product mix, while international gross margins declined 120bp due to special one-time charges. International gross margins were also impacted by higher raw material costs which were offset by higher volumes and a more favorable product mix. The company reported a twelve-month backlog of $913M and total backlog of $1.6B. Quarterly bookings were $581M. Management noted that it had met all of its major objectives for the year, including the successful deployment of smart metering solutions for large contracts in North America, preparing for opportunities in Europe and other regions abroad, and expanding the gas and water businesses. FY11 EPS, excluding some items, is expected to be $3.95-4.40/share a share on sales of $2.15B to $2.3B, according to the company. ITRI was expected to earn $4.37 a share on sales of $2.3B, based on consensus estimates.

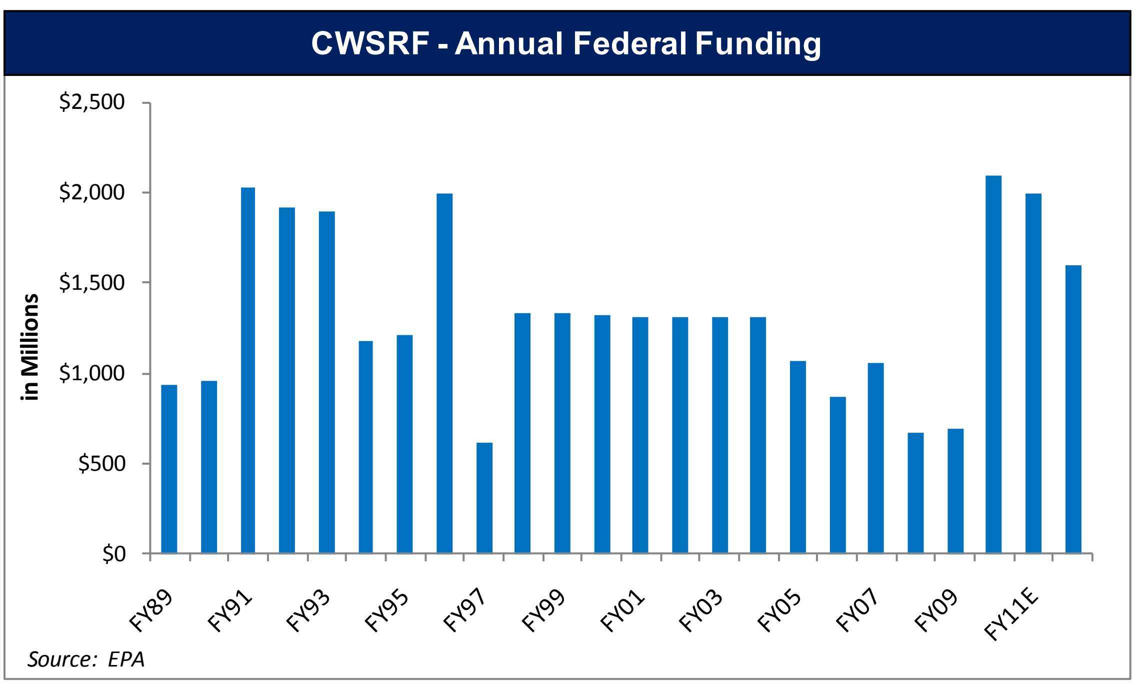
END MARKET AND INDUSTRY UPDATES

Obama's FY12 Budget Request Cuts Water Grants – The U.S. EPA would take a 12.6% cut under President Obama's FY12 budget request, thereby reducing the amount of grants available for state and local water projects, while maintaining funding levels for new air pollution regulations. Obama has reduced the EPA's budget by $1.3B to $9B, whereas Republicans are hoping to slash the budget by more than $3B to $7.5B. Of the $1.3B in funding cuts in the president's proposal, about $117M would come from federal operations and the rest would mainly come from grants. The Clean Water and Drinking Water State Revolving Funds would receive $1.6B (-20% y/y) and $990M (-23% y/y), respectively, representing an overall cut of $947M for the two programs. The budget also scraps $167M in water infrastructure funding, $157M of which had been earmarked by members of Congress. State agencies have been bracing for cuts in state revolving funds, after both witnessed a large spike in contributions thanks to the stimulus. The $550M cut to clean water grants and the $397M cut to drinking water grants could cause some of those projects to be delayed by a year or longer, according to government officials.
Source: The New York Times

LBR Note: As a reminder, Federal SRF funding provides grants to states for low-interest loans to communities through a combination of Federal capitalization, State matches, State leveraging, interest, and loan repayments. While the reduction will obviously negatively impact a number of large-scale projects on the state level, we note that SRF funding accounts for ~15% of total spending on water infrastructure on the state and local level. Indeed, more than 50% of the annual investment in water infrastructure is funded by revenues generated by municipal water utilities for services provided.

Flood of Money Needed to Fix China's Water Woes – While China may now be the world's second largest economy, hundreds of millions of its people still rely on fouled water that will undoubtedly cost hundreds of billions to clean in the coming years. Indeed, the country's own rapid growth has come at the expense of its water supplies. Growing cities, overuse of fertilizers, and factories that heedlessly dump wastewater have degraded China's water supplies to the extent that half the nation's rivers and lakes are severely polluted. China now needs to spend up to $20B a year to bring its urban water supplies up to par, according to the World Bank. While larger cities have already begun making the needed investments, smaller cities and the countryside have fallen short, leaving more than 800M people without clean drinking water. Reflective of the needed investment, water infrastructure was highlighted in government's first policy document of 2011, with $606B allocated for water clean-up and rural water infrastructure over the next decade. Foreign companies have already begun investing in the Chinese water market, deploying some $1.7B in capital from 2004-09 and investing more than $500M in 2009 alone. The projects include wastewater treatment, municipal water supply, industrial water supply and direct investment in Chinese water companies. Specifically, French water giants Suez Environment (SEV.FR, NR) and Veolia (VE, NR) are both major players in the Chinese municipal water market, with over 17 service contracts each. However, both companies face rising competition for large contracts in China by domestic competitors, including Beijing Capital Co. These companies continue avoided the residential market, however, due to low residential tariffs. China's water tariffs remain low among comparable economies, despite the doubling in average water tariffs in recent years to $0.39/cubic meter. Indeed, reflective of these low rate, China accounts for 20% of Suez' water customer (14M people), but just 7% of its revenues. Such companies have instead focused on securing more profitable industrial contracts.
Source: Reuters


DWSRF - Annual Federal Funding
$1,600
$1,400
$1,200
$1,000
$800
$600
$400
$200
$0
in Millions
FY97
FY98
FY99
FY00
FY01
FY02
FY03
FY04
FY05
FY06
FY07
FY08
FY09
FY10
FY11E
FY12E
Source: EPA


CWSRF - Annual Federal Funding
$2,500
$2,000
$1,500
$1,000
$500
$0
in Millions
FY89
FY91
FY93
FY95
FY97
FY99
FY01
FY03
FY05
FY07
FY09
FY11E
Source: EPA

WATER INDUSTRY PEER VALUATION

($ in millions, except per share data)

Company	Ticker	FY End	Rating	Target	% Upside	Share Price	52 Week Hi	52 Week Lo	Mkt Cap	Revenue Last	Earnings per Share Last FY	Earnings per Share Current FY	Earnings per Share Next FY	P/E Current FY	P/E Next FY	Dividend Rate	Price/ Book
U.S. WATER UTILITIES																	
AMER STATES WATER	**AWR**	**Dec.**	**Neutral**			**$33.46**	**$39.61**	**$31.24**	**$ 623**	**$ 361**	**1.62**	**1.78**	**2.15**	**18.8x**	**15.6x**	**3.1%**	**1.8x**
AMERICAN WATER WORKS	**AWK**	**Dec.**	**BUY**	**$29**	**7%**	**$27.00**	**$26.88**	**$19.41**	**$ 4,722**	**$ 2,851**	**1.25**	**1.53**	**1.72**	**17.6x**	**15.7x**	**3.3%**	**1.0x**
AQUA AMERICA	**WTR**	**Dec.**	**Neutral**			**$23.44**	**$23.79**	**$16.52**	**$ 3,224**	**$ 671**	**0.77**	**0.91**	**1.00**	**25.8x**	**23.5x**	**2.6%**	**2.2x**
CALIFORNIA WATER	**CWT**	**Dec.**	**Neutral**			**$36.10**	**$39.70**	**$33.81**	**$ 752**	**$ 449**	**1.95**	**1.91**	**2.20**	**18.9x**	**16.4x**	**3.4%**	**1.8x**
ARTESIAN RESOURCES	ARTNA	Dec.	NR			$19.25	$19.66	$16.43	$ 145	$ 61	1.04	*1.15*	*1.24*	16.7x	15.5x	3.9%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			$24.80	$28.27	$20.00	$ 215	$ 59	1.20	*1.2*	*1.28*	20.7x	19.4x	3.8%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			$18.64	$19.31	$14.74	$ 290	$ 91	0.94	*0.95*	*0.95*	19.6x	19.6x	3.9%	1.7x
PENNICHUCK	PNNW	Dec.	NR			$28.16	$28.39	$19.64	$ 131	$ 33	0.84	*0.95*	*1.15*	29.6x	24.5x	2.6%	1.8x
SJW	SJW	Dec.	NR			$24.53	$28.24	$21.70	$ 455	$ 216	0.98	*1.06*	*1.20*	23.1x	20.4x	2.8%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			$17.26	$18.00	$12.83	$ 219	$ 37	0.71	*0.76*	*0.81*	22.7x	21.3x	3.0%	2.1x
Average														21.4x	19.2x	3.2%	1.7x
EQUIPMENT/ FILTRATION/ TREATMENT SECTOR																	
PENTAIR	**PNR**	**Dec.**	**BUY**	**$41**	**7%**	**$38.17**	**$39.32**	**$29.41**	**$ 3,767**	**$ 3,031**	**-16.87**	**-10.43**	**1.01**	**-3.7x**	**37.8x**	**2.1%**	**1.6x**
WATTS WATER TECH	**WTS**	**Dec.**	**Neutral**			**$40.11**	**$40.16**	**$27.51**	**$ 1,485**	**$ 1,234**	**1.54**	**1.92**	**2.23**	**20.9x**	**18.0x**	**1.1%**	**1.3x**
AMERON INT'L	AMN	Nov.	NR			$72.16	$85.25	$55.42	$ 668	$ 503	5.10	*3.22*	*4.25*	22.4x	17.0x	1.7%	1.1x
BADGER METER	BMI	Dec.	NR			$41.07	$45.49	$35.35	$ 617	$ 277	1.88	*2.05*	*2.31*	20.0x	17.8x	1.4%	3.9x
CALGON CARBON	CCC	Dec.	NR			$14.13	$18.35	$11.75	$ 796	$ 412	0.68	*0.86*	*0.98*	16.4x	14.4x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			$3.45	$6.77	$3.08	$ 181	$ 47	-0.08	-	*0.14*	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			$43.94	$44.61	$27.04	$ 1,020	$ 626	1.86	*2.29*	*2.69*	19.2x	16.3x	1.2%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			$38.05	$38.59	$22.81	$ 639	$ 297	1.53	*1.75*	*2*	21.7x	19.0x	1.1%	2.6x
ITRON	ITRI	Dec.	NR			$63.90	$81.95	$52.03	$ 2,582	$ 1,687	4.06	*4.38*	*4.35*	14.6x	14.7x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			$32.66	$36.92	$22.97	$ 639	$ 866	1.42	*1.63*	*1.63*	20.0x	20.0x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			$4.04	$5.99	$2.21	$ 628	$ 1,338	-0.19	*0.01*	*0.15*	NM	NM	1.7%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			$23.68	$25.50	$14.62	$ 220	$ 283	0.12	*0.73*	*1.47*	32.4x	16.1x	0.0%	1.0x
PALL	PLL	Jul.	NR			$55.82	$55.68	$31.84	$ 6,430	$ 2,402	2.12	*2.79*	*2.79*	20.0x	20.0x	1.3%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			$42.29	$45.80	$29.03	$ 1,937	$ 2,026	2.87	*2.07*	*2.47*	20.4x	17.1x	1.3%	1.9x
Average														21.2x	17.6x	0.7%	2.0x
WATER RESOURCES/ INFRASTRUCTURE																	
INSITUFORM TECH	INSU	Dec.	NR			$29.86	$29.97	$18.52	$ 1,171	$ 727	1.52	*1.80*	*2.31*	16.6x	12.9x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			$74.33	$72.80	$30.80	$ 931	$ 358	1.83	*2.22*	-	34.0x	27.3x	0.5%	2.0x
TETRA TECH	TTEK	Sept.	NR			$23.97	$27.16	$18.00	$ 1,480	$ 2,201	1.22	*1.41*	*1.65*	17.2x	15.1x	0.0%	1.7x
Average														21.6x	18.3x	0.6%	2.2x

Relevant Indices		**Share Price**
Dow Jones Industrials	DJ30	$12,268
S&P 500	SPX	$1,332
Nasdaq Composite	NDX	$2,386

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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Sell	2	0.9%

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period.

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