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Industry: **WATER INFRASTRUCTURE**

## Coverage:

<b>Ticker</b>	<b>Rating</b>	<b>Price</b>
AWK	BUY	\$25.38
AWR	NEUTRAL	\$33.90
CWT	NEUTRAL	\$36.58
PNR	BUY	\$35.77
WTR	NEUTRAL	\$23.18
WTS	NEUTRAL	\$35.71

## The Water Rundown

### Water Utilities Updates

- AWK Announces Acquisition
- Increase in Main Breaks Limits WTR's 4Q Upside
- Texas' Lower Colorado River Authority Selling its Water and Wastewater Assets

### Water Infrastructure Updates

- AMN Reports Earnings
- PLL CEO to Retire, Top Lawyer Resigns
- WTS CEO Resigns Citing Health
- Suez to Fight Hungary Contract Loss in Court

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- Outlook Stable for U.S. Water and Wastewater, says Fitch
- Negative Ratings Pressure Mounts for UK Water Companies
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- Average Daily Domestic Water Use
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**IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.**



## **WATER UTILITIES UPDATES**

**AWK Announces Acquisition** – AWK (B, \$29PT) announced that its Missouri subsidiary has acquired the Loma Linda water system. The system adds 303 customers to the company's customer base. Missouri American Water is currently installing a new water pipeline to connect the Loma Linda system to its existing facilities.

*Source: Longbow Research*

**Increase in Main Breaks Limits WTR's 4Q Upside** - WTR announced early last week that cold weather in southern PA resulted in more than twice the normal number of water main breaks (185) during the month of December. As a result, the company realized greater-than-expected operating expenses associated with the repair and replacement of those damaged water mains. Consequently, management suggested that 4Q10 EPS would largely come in line with its previously stated guidance of \$0.21. The company indicated that the higher expenses were from breaks in older pipes, and newly installed pipes as part of the company's five-year \$1.3B capex program were largely unaffected. Based on our most recent survey, we believed that strong consumption trends in a number of the company's markets would lead to EPS upside. While we continue to expect a revenue outperformance, given the new information, we reduced our 4Q10E EPS by \$0.03 to \$0.21 on January 26, 2011 to account for weaker margins associated with the moderately higher repair costs. To see our full article, reference *WTR: Increase in Water Main Breaks Limits 4Q Upside Potential* published on January 26, 2011.

*Source: Longbow Research*

**Texas' Lower Colorado River Authority Selling its Water and Wastewater Assets** – Central Texas' Lower Colorado River Authority (LCRA) is seeking to exit the water and wastewater business and WTR (N) has emerged as a frontrunner in the bidding process. LCRA directors voted last November to sell its 32 water and wastewater facilities that it has built and/or acquired over the past 15 years. A number of the systems are near Austin. LCRA seeks to exit the water business as it only accounts for ~3% of its total revenues and the assets are not generating a profit. WTR, which generates more than 8% of its revenues in Texas and recently expanded its footprint in the state through an asset swap deal with AWK, has announced that it is "absolutely" interested in the LCRA utilities. The LCRA and WTR have done business together a number of times. Indeed, in 2010, WTR bought a number of systems near Austin from the LCRA. That being said, there is no assurance that WTR will be able to purchase all of the assets outright, as the LCRA is negotiating with six communities about purchasing the systems that serve them. LCRA officials would not disclose an asking price for the system, but did note that they had invested more than \$300M in constructing and upgrading the systems over the years.

*Source: American Water Intelligence*

*LBR Note: Given the recent portfolio swap with AWK, Texas appears to be a focus for WTR management as it will allow the company to increase its foothold in a fast-growth market, while simultaneously reducing its dependence on Pennsylvania, where it generates ~52% of its revenues. Though management has yet to offer its acquisition growth target for FY11, we expect them to remain focused on expanding through a number of small to medium size tuck-in acquisitions that will allow the company to expand its existing footprint in a number of fast-growth geographic markets. Along those lines, the LCRA's assets are undoubtedly a notable opportunity for WTR to expand its portfolio in the state. Furthermore, while the article noted that the LCRA has been unable to generate a profit on its systems, WTR should be able to streamline the facilities to make them more efficient and furthermore create economies of scale in hopes of turning a profit.*

## **WATER INFRASTRUCTURE UPDATES**

**Ameron Reports Earnings** – AMN (NR) reported 4Q10 EPS of \$2.88/share compared to \$1.53 during the year ago period. Revenues of \$124M during 4Q10 came in below consensus estimates of \$128M. The quarter included a pretax gain of \$48M related to the sale of the company's steel mini-mill to TAMCO, which was offset by a pretax expense of \$0.9M related to an unexpected legal judgment. For FY11, the company expects earnings in the range of \$3.00-3.50/share. However, management noted that 1Q11 is off to a slow start due to weather delays and project timing. It went on to say that full year remains heavily dependent on the recovery in construction markets and the ongoing progress of the Company's internal initiatives, with potential upside in the Fiberglass-Composite Pipe Group. In regard to the various operating segments, the Fiberglass-Composite Pipe Group strengthened in the fourth quarter as sales increase to \$65M, from \$56M during the year ago period. Fourth quarter and FY10 sales rose primarily in key onshore oilfield and mining markets in North and South America. Sales into the marine and offshore energy exploration and production markets declined, while lower-margin industrial sales increased. Margins were negatively impacted by a mix-shift to lower margin products throughout the course of the year. Going forward, the company expects this segment to see strong demand due primarily to energy-related projects. Water Transmission Group's sales were \$29M during 4Q10, compared to sales of \$44M in 4Q09. The bulk of the declines were a result of a pullback in the company's wind tower business. The segment posted a loss of \$1.5M during the quarter and \$1M during FY10. In addition, the company's water business is also expected to experience soft market demand. Indeed, management noted that the timing of bid activity has been negatively affected by the economy, municipal budgets and availability of financing. Furthermore, management was unsure when water agencies and municipalities would proceed with backlogged projects.

*Source: Company Reports, Longbow Research*



**Pall Corp. CEO to Retire, Top Lawyer Resigns** – PLL (NR) announced that Eric Krasnoff plans to retire as chairman, president and CEO by his 60th birthday next March, or earlier if a successor is found, after 17 years with the company. The announcement follows a notice sent to the company's Board by Krasnoff and the company's General Counsel, Sandra Marino, that the two intend to pursue a personal relationship and that, consequently, Ms. Marino would be resigning from her post.

*Source: Longbow Research*

**WTS CEO Resigns Citing Health**– WTS (N) reported that Patrick O'Keefe has resigned from his positions as President, Chief Executive Officer and Director of the Company for unnamed health reasons. He will remain with the Company in a non-executive advisory role for "several months." O'Keefe did not offer a statement in the press release despite his abrupt departure. David Coghlan, COO, will assume O'Keefe's prior roles effective immediately. Coghlan first joined the company in 2008 as President of North America and Asia and was promoted to COO in January 2010. He has previously worked for Trane Inc, Ingersoll-Rand, and McKinsey & Co. both in the U.S. and Europe in a number of upper-management positions.

*Source: Longbow Research*

*LBR Note: In that the company has an experienced management team, we would expect the transition to be smooth. Furthermore, Coghlan's knowledge of international markets, as evidenced by his previous roles with a number of multinational companies, should support the company's ongoing plans to expand its foothold in China and other international markets.*

**Suez to Fight Hungary Contract Loss in Court** – Suez Environment (SEV.FR, NR), whose water services contract with the Hungarian city of Pécs was terminated without warning by the municipality, intends to take the battle to an international court of arbitration. The municipality, which owns 51% of the Pécs Water Company, while Suez owns 49%, abruptly ended the contact in September 2009, claiming that Suez's water tariff increases went against the best interests of the customers. Suez has denounced the accusation, insisting that the council had the last word on major decision-making at the water company.

*Source: Global Water Intelligence*

## **END MARKET & INDUSTRY UPDATES**

**Outlook Stable for U.S. Water and Wastewater, says Fitch** – Despite concerns related to current economic, capital, and political pressures, Fitch Ratings' outlook for the municipal water and wastewater sector is stable, according to a report released by the debt ratings company. The group notes that

the sector remains strong overall and should sustain its stability through the year even though negative rating actions have increased in the past couple of years. "Most systems exhibit more than sufficient financial flexibility. However, timely rate recovery will be important to maintaining financial profiles and positioning systems to meet their long-term capital and service demands," said Doug Scott, Managing Director at Fitch. Despite the economic downturn, these fundamentals have insulated the sector from the various swings realized in many other industries, according to the group.

*Source: Business Newswire*

*LBR Note: In that municipalities rely heavily on borrowing to fund water infrastructure improvements, favorable debt ratings by the major ratings agencies is essential to maintaining low borrowing costs. In the scenario of debt downgrades leading to higher borrowing costs, municipalities may find themselves pulling back on infrastructure investments, which would negatively impact a number of water infrastructure product providers.*

### **Negative Ratings Pressure Mounts for UK Water Companies**

– A number of UK water and sewerage companies risk downgrades to their credit ratings if their managements cave in to investor pressure on dividends, Fitch, a debt ratings agency, has warned. The group noted that the while it is unlikely that it will downgrade the credit of the broader industry, given that there would be no fundamental change to the regulatory regime in the medium term, it did note that at the individual company level, "negative rating action could follow if executive teams were to give way to shareholder pressure." The group went on to note that while company revenues and asset values would benefit from rising inflation, the operating environment would remain "challenging" due to bad debts and escalating costs associated with carbon allowance purchases. According to Fitch, industry wide bad debts rose in 2010 and it warned that the problem may get worse as more customers realize that companies cannot legally cut off their supplies.

*Source: Global Water Intelligence*

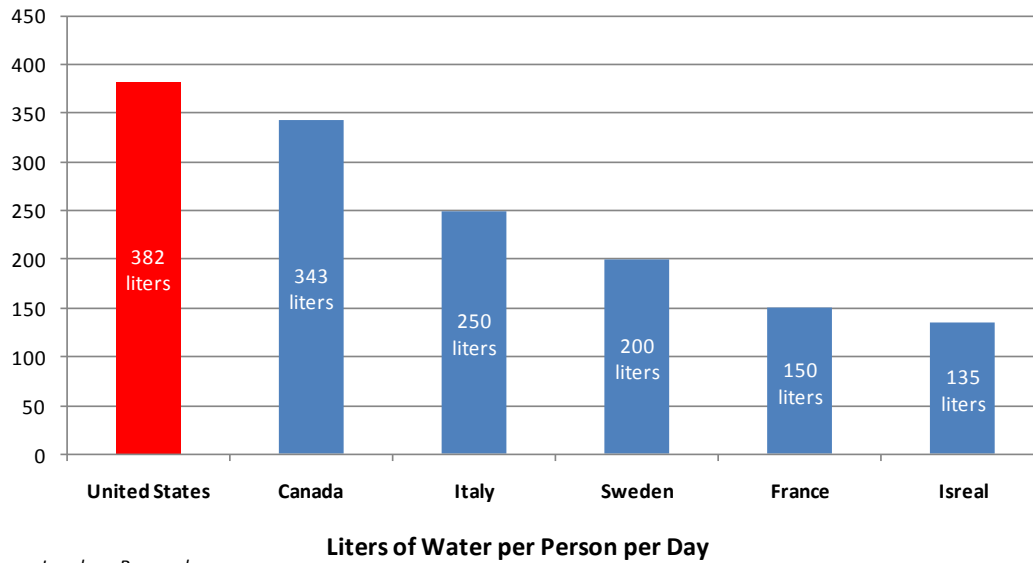
### **China to Spend \$430M to Cope with Worsening Drought** –

China has announced that it will spend an additional \$430M to alleviate an unyielding drought in the northern and southern parts of the country that has negatively impacted this seasons crop and left about 2.6M people short of drinking water. The investment comes in addition to a \$779B spending plan that will be implemented over a 10 year period to improve water conservation efforts and irrigation facilities.

*Source: AsiaOne News*

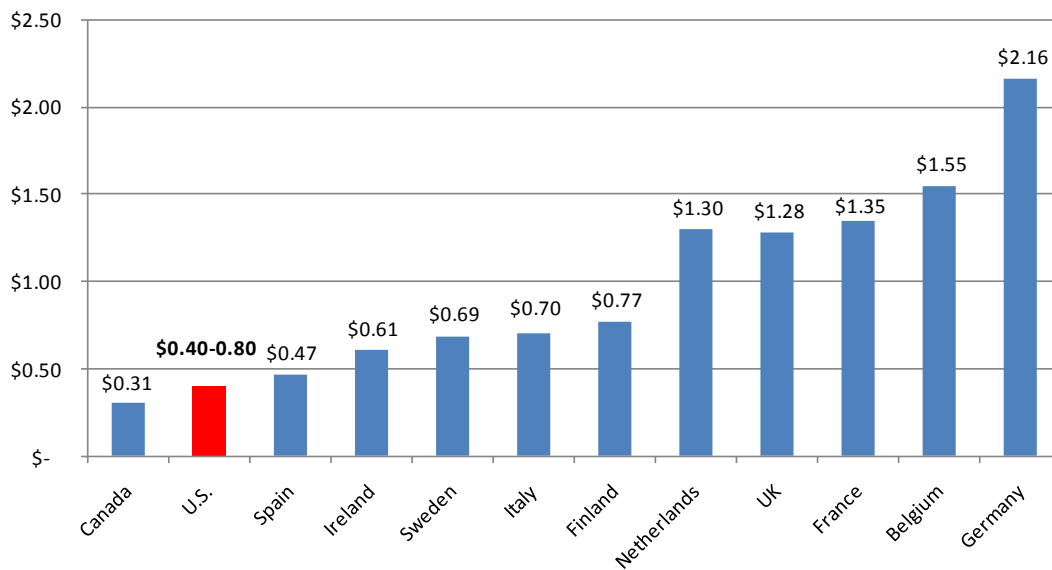


### Average Daily Domestic Water Use (per capita)



Source: Longbow Research

### Typical Municipal Water Rates by Country



**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		
<b>U.S. WATER UTILITIES</b>																	
AMER STATES WATER	AWR	Dec.	Neutral			\$33.90	\$39.61	\$31.20	\$ 631	\$ 361	1.62	1.78	2.15	19.1x	15.8x	3.1%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	14%	\$25.38	\$26.34	\$19.41	\$ 4,438	\$ 2,849	1.25	1.58	1.72	16.1x	14.8x	3.5%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$23.18	\$23.79	\$16.45	\$ 3,188	\$ 671	0.77	0.93	1.00	24.9x	23.3x	2.7%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$36.58	\$39.70	\$33.81	\$ 762	\$ 449	1.95	1.91	2.20	19.1x	16.6x	3.4%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$19.02	\$19.63	\$16.43	\$ 144	\$ 61	1.02	1.11	1.24	17.1x	15.3x	4.0%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$24.40	\$28.27	\$20.00	\$ 211	\$ 59	1.20	1.2	1.28	20.3x	19.1x	3.8%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$17.67	\$19.31	\$14.74	\$ 275	\$ 91	0.94	0.95	0.95	18.6x	18.6x	4.1%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$28.03	\$28.39	\$19.00	\$ 131	\$ 33	0.84	0.95	1.15	29.5x	24.4x	2.6%	1.8x
SIW	SIW	Dec.	NR			\$24.46	\$28.24	\$21.60	\$ 454	\$ 216	0.98	1.06	1.20	23.1x	20.4x	2.8%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$16.09	\$18.00	\$12.83	\$ 204	\$ 37	0.71	0.76	0.81	21.2x	19.9x	3.3%	2.1x
Average														20.9x	18.8x	3.3%	1.7x
<b>EQUIPMENT/ FILTRATION/ TREATMENT SECTOR</b>																	
PENTAIR	PNR	Dec.	BUY	\$39	9%	\$35.77	\$39.32	\$29.41	\$ 3,530	\$ 2,692	1.47	1.96	2.28	18.2x	15.7x	2.2%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$35.71	\$37.79	\$27.51	\$ 1,322	\$ 1,234	1.54	1.92	2.23	18.6x	16.0x	1.2%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$74.36	\$85.25	\$55.42	\$ 688	\$ 547	2.90	3.84	4.54	19.4x	16.4x	1.6%	1.1x
BADGER METER	BMI	Dec.	NR			\$40.47	\$45.49	\$32.58	\$ 608	\$ 250	1.91	2.07	2.32	19.6x	17.4x	1.4%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$14.10	\$18.35	\$11.75	\$ 794	\$ 412	0.68	0.86	0.98	16.4x	14.4x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.38	\$6.77	\$3.08	\$ 177	\$ 47	-0.08	-	0.14	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$41.03	\$43.49	\$24.93	\$ 952	\$ 626	1.86	2.29	2.69	17.9x	15.3x	1.3%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$31.22	\$37.40	\$22.81	\$ 524	\$ 266	1.34	1.60	1.88	19.5x	16.6x	1.3%	2.6x
ITRON	ITRI	Dec.	NR			\$57.83	\$81.95	\$52.03	\$ 2,337	\$ 1,687	4.06	4.35	4.39	13.3x	13.2x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$31.42	\$36.92	\$22.97	\$ 615	\$ 866	1.42	1.63	1.63	19.3x	19.3x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$4.05	\$5.99	\$2.21	\$ 627	\$ 1,338	-0.19	0.13	0.15	NM	NM	1.7%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$21.44	\$25.50	\$14.62	\$ 199	\$ 283	0.12	0.73	1.47	29.4x	14.6x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$48.66	\$51.16	\$31.84	\$ 5,605	\$ 2,402	2.12	2.79	2.79	17.4x	17.4x	1.4%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$42.30	\$45.80	\$27.39	\$ 1,938	\$ 2,026	2.87	2.91	3.04	14.5x	13.9x	1.3%	1.9x
Average														18.8x	15.7x	0.8%	2.0x
<b>WATER RESOURCES/ INFRASTRUCTURE</b>																	
INSITUFORM TECH	INSU	Dec.	NR			\$26.33	\$29.17	\$18.52	\$ 1,033	\$ 727	1.52	1.80	2.31	14.6x	11.4x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$63.76	\$72.80	\$30.80	\$ 799	\$ 358	1.83	2.22	-	29.2x	23.4x	0.5%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$23.13	\$27.16	\$18.00	\$ 1,429	\$ 2,201	1.22	1.43	-	16.8x	14.7x	0.0%	1.7x
Average														18.6x	16.1x	0.7%	2.2x
<b>Relevant Indices</b>						<b>Share Price</b>											
Dow Jones Industrials		DJ30				\$11,824											
S&P 500		SPX				\$1,276											
Nasdaq Composite		NDX				\$2,271											

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	148	63.0%
Sell	2	0.9%

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"Buy" means that Longbow Securities expects total return to exceed 20% over a 12-month



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period.

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