

Water Utilities, Flow Technology and Purification

March 28, 2011

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U.S. Water Utility Quarterly Wrap-up

West Coast and East Coast U.S. Utilities

Company	Ticker	Rating	Price	Target	11E EPS / (P/E)	12E EPS / (P/E)
American Water Works Company, Inc.	AWK	Buy	\$27.78	\$35.00	\$1.77 (15.7x)	\$1.85 (15.0x)
American States Water Company	AWR	Buy	\$34.16	\$39.00	\$2.15 (15.9x)	\$2.29 (14.9x)
California Water Service Group	CWT	Buy	\$36.10	\$44.00	\$2.18 (16.6x)	\$2.37 (15.2x)
SJW Corp.	SJW	Hold	\$22.65	NA	\$0.96 (23.6x)	\$0.87 (26.0x)
Aqua America, Inc.	WTR	Buy	\$22.48	\$26.00	\$0.98 (22.9x)	\$1.07 (21.0x)
The York Water Company	YORW	Buy	\$16.62	\$20.00	\$0.75 (22.2x)	\$0.79 (21.0x)

Investment Summary

Now that each of the companies we follow within the U.S. water utility industry has reported 4Q10 results, we are taking this opportunity to review developments and trends we've seen across the landscape. We will discuss regulatory environments, water supply issues, valuation, upside potential, share performance, yields, and our favorite picks for both West coast and East coast operators.

**West Coast**

We will begin our discussion with the West coast (specifically California) publicly traded water utilities, which include **American States Water (AWR, \$34.16, Buy)**, **California Water Service Group (CWT, \$36.10, Buy)**, and **San Jose Water (SJW, \$22.65, Hold)**.

**Regulatory Environment**

In California, the Public Utilities Commission (CPUC) is composed of five Governor-appointed commissioners and regulates various utilities (including water). The commissioners must be confirmed by the Senate for six year staggered terms. Perhaps the most important action of the CPUC that we track is the rates of returns that it sets for publicly traded water companies. This year, three new commissioners have been appointed. Mike Florio and Catherine J.K. Sandoval were each appointed on January 25, 2011, and Mark Ferron was appointed on March 22, 2011. Mr. Florio previously was a senior attorney at The Utility Reform Network (TURN) and served in that position since 1978. Mrs. Sandoval is a Santa Clara University law professor, telecommunications expert and former Rhodes Scholar. Mr. Ferron is a senior partner at Silicon Valley Social Ventures and is a board fellow of the New Teacher Center, and previously worked as chief operating officer for the Global Markets Division of Deutsche Bank in London. While none of these appointments have been exceptionally inspiring, it is important to point out the potential negative that could come from having a former TURN attorney on the commission. TURN is a consumer advocacy group aimed at saving utility customers money by lowering utility bills. In our view, having a former attorney for TURN on the CPUC could potentially have negative effects for the water companies if they do not provide adequate and fair rates. That said, with rate case activity all but finalized with the three California utilities, we don't see the changes impacting 2011/2012 results substantively.

**Water Supply**

Surface water supply conditions in California are doing very well for this time of year. As recently as a few weeks ago, the water content in the snow of the Sierra Mountains was well above normal for March. The mountains contain more frozen water than would be standard even a month from now according to measurements taken manually and electronically throughout the state. And according to forecasts, there's more rain and snow coming. The water content of the snow is what is used to predict how much surface water will be available in California during the year. Water content statewide is 124% of normal for this time of year. Furthermore, drought conditions also appear to have eased substantially, which we display in Ex. 1:

**Exhibit #1**

**U.S. Drought Monitor**  
California

March 15, 2011  
Valid 7 a.m. EST

	Drought Conditions (Percent Area)					
	None	D0-D4	D1-D4	D2-D4	D3-D4	D4
Current	94.20	5.80	0.00	0.00	0.00	0.00
Last Week (03/08/2011 map)	94.20	5.80	0.00	0.00	0.00	0.00
3 Months Ago (12/14/2010 map)	79.56	20.44	1.25	0.00	0.00	0.00
Start of Calendar Year (12/28/2010 map)	98.62	1.38	0.00	0.00	0.00	0.00
Start of Water Year (09/28/2010 map)	85.44	14.56	8.08	0.24	0.00	0.00
One Year Ago (03/09/2010 map)	66.67	33.33	10.91	5.88	0.00	0.00



*Intensity:*

- D0 Abnormally Dry
- D1 Drought - Moderate
- D2 Drought - Severe
- D3 Drought - Extreme
- D4 Drought - Exceptional

The Drought Monitor focuses on broad-scale conditions. Local conditions may vary. See accompanying text summary for forecast statements.

<http://drought.unl.edu/dm>



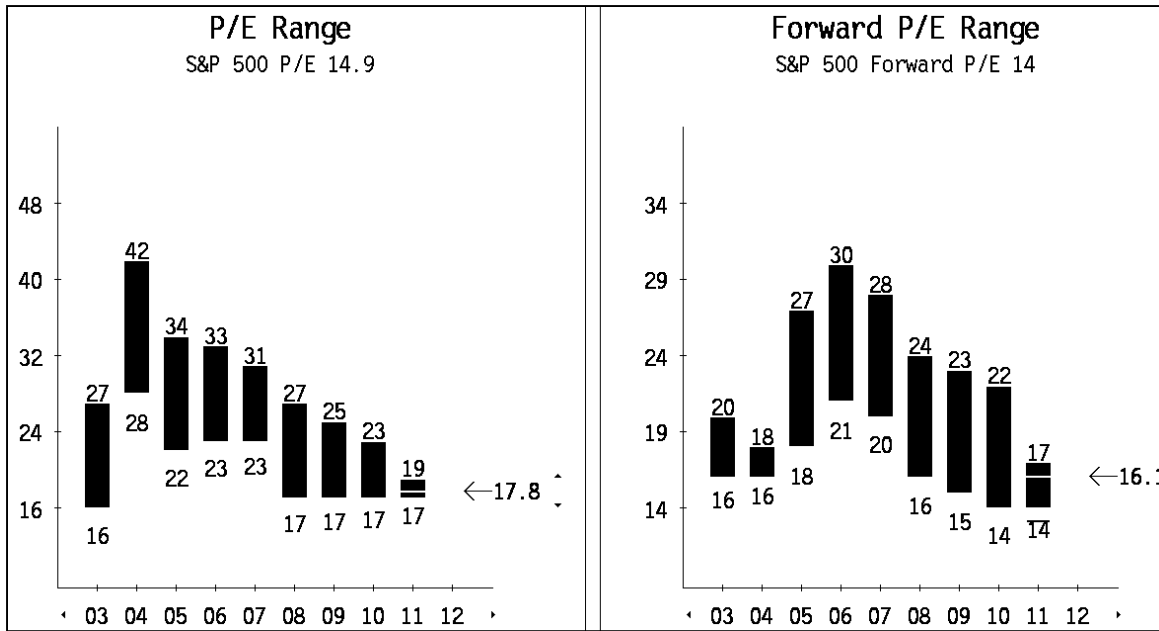
Released Thursday, March 17, 2011  
Laura Edwards, Western Regional Climate Center

A solid water supply coupled with an easing drought situation throughout the state should set the stage for superior performance from the water companies heading into the all-important summer quarters.

**Compelling Valuation**

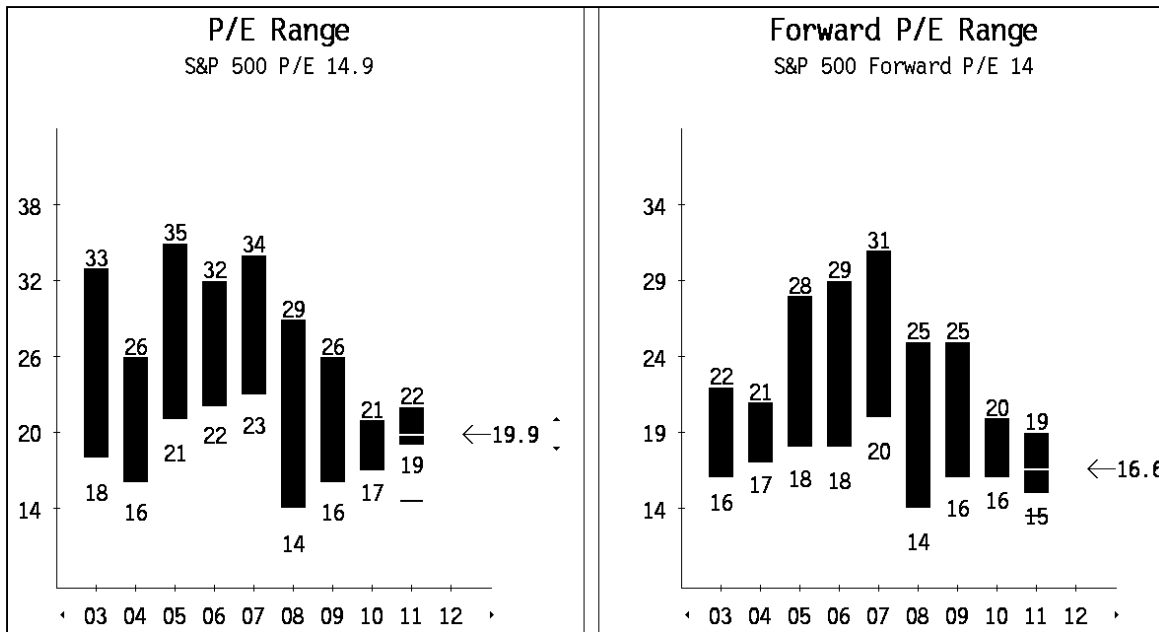
The three companies in the state all appear to be trading at compelling levels based on where they've historically traded:

**American States Water Historical Trailing and Forward P/E Ratios, 2003 – 2011**



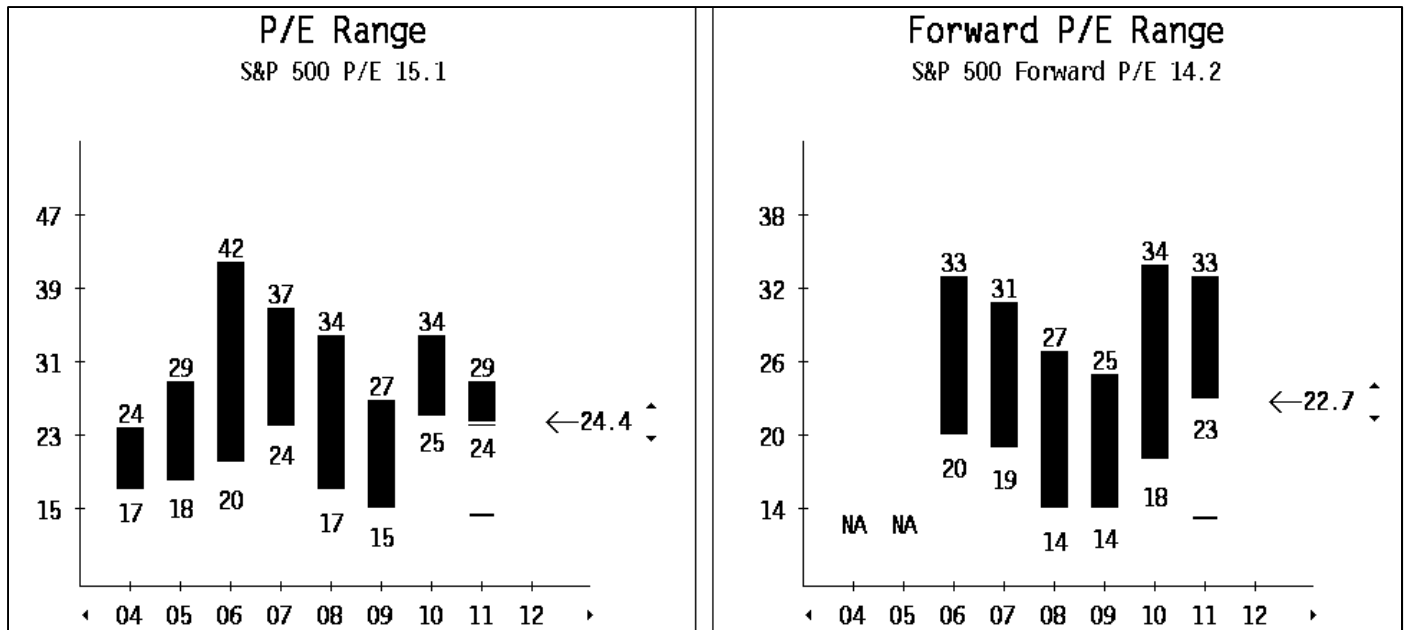
Source: Baseline

**California Water Service Group Historical Trailing and Forward P/E Ratios, 2003 – 2011**



Source: Baseline

San Jose Water Historical Trailing and Forward P/E Ratios, 2004 – 2011



Source: Baseline

As we can see from the charts, AWR and CWT are trading near their historical lows for the past several years; while SJW is trading at a level we consider fair value. We believe AWR and CWT have significant upside potential on a strictly P/E basis.

Share Performance

Since reporting 4Q10 results, our Buy-rated California Utility names (AWR and CWT, both of which we upgraded after their respective releases) have ticked up slightly (3.7% and 2.0%, respectively), while our Hold-rated name (SJW) has dropped off a bit (-5.3%).

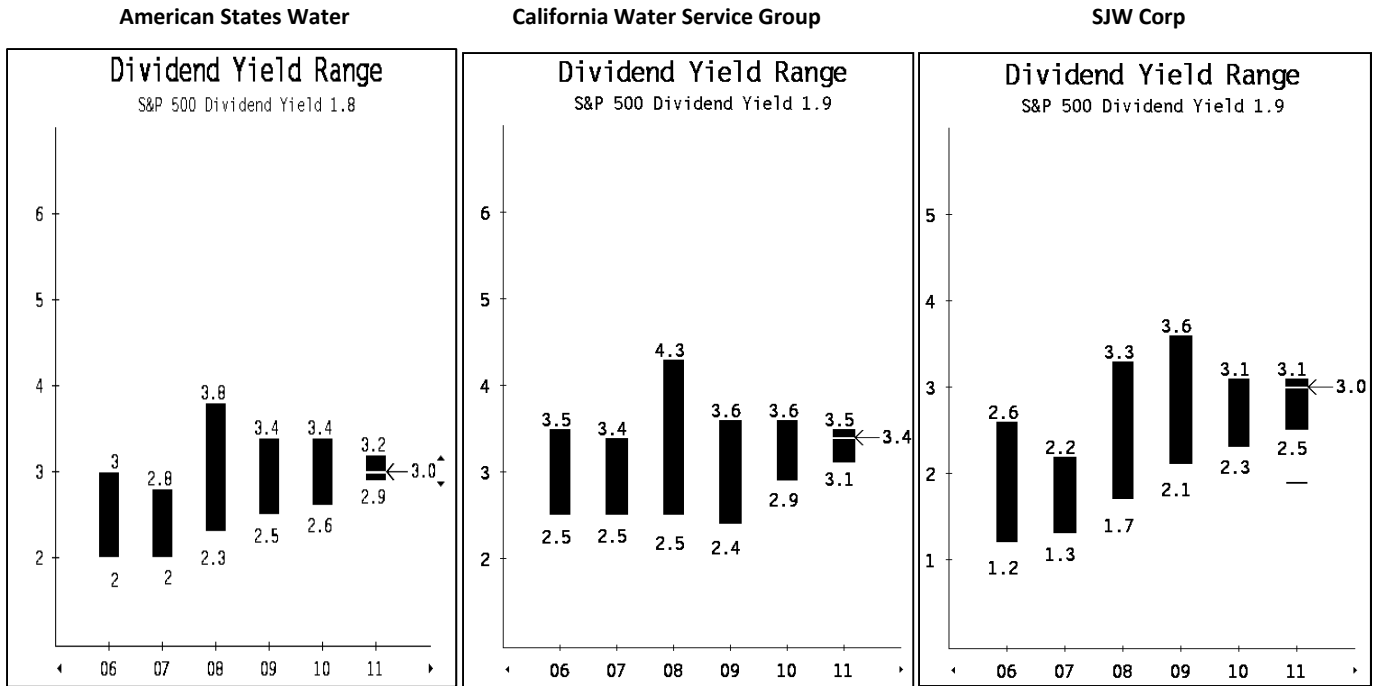
	4Q10 Report Date	Share Price on Report Date	Share Price (03/25/11)	% Change
AWR	3/14/2001	\$32.93	\$34.16	3.7%
CWT	2/24/2011	\$35.39	\$36.10	2.0%
SJW	2/24/2011	\$23.93	\$22.65	-5.3%

Source: Baseline

**Dividend Yields 3.0% +**

Across the California utility landscape, each of the names is yielding no less than 3%, towards the top end of the five-year range:

**California Water Utility Dividend Yields, 2006 – 2011 (AWR, CWT, SJW)**



Source: Baseline

**Outlook for Each Name**

**AWR:** While 2010 was not the best of years for American States Water as one-time items obscured the earnings potential in the underlying business model, we believe the stage is set for favorable YoY comparisons going forward. Additional upside lies in the improving outlook for military utility privatizations; the major water/wastewater contracts to be awarded by the Department of Defense is an \$11 billion revenue market opportunity. We expect AWR (and its competitor, American Water Works) will benefit, given its experience in this end market via existing military base operations. Additionally, the shares have traded off significantly since November 2010 and are now at a level we consider attractive from both a P/E and dividend yield perspective. On top of valuation, we also note the Sierra snowpack remains above normal levels for this time of year, setting the stage for improved surface water supplies in the coming peak summer season. We maintain our Buy rating and \$39 target price, based on the shares attaining a level of 18x our 2011 EPS estimate of \$2.15.

**CWT:** With the shares of CWT trading at approximately 16x our 2011 EPS estimate of \$2.18 and the highest yield among the California utility peer group (3.4%), we consider them attractive at current levels. In December of 2010, CWT was awarded its 2009 General Rate Case, which authorized the company to realize an additional \$25 million in revenue, as well as an additional \$8 million in revenue to be obtained when certain projects are completed, so revenue and earnings should increase substantially YoY. With that as the backdrop, we became more favorably biased to the name, based on future prospects and yield. At \$36 per share, the implied yield is 3.4%, a good place to own historically and toward the top of the range. The total return outlook is favorable in our opinion and we recommend investors purchase shares, particularly at or below the \$36 level. We maintain our Buy rating and \$44 target price based on the shares attaining a level of 20x our 2011 EPS estimate of \$2.18.

**SJW:** We note that despite relatively flat-to-down EPS performance when measured against 2005, the shares of SJW recently traded at what we considered a premium valuation relative to the water utility peer group. With the shares currently trading at 23x our 2011 EPS estimate of \$0.96, we consider them fairly priced, but becoming modestly attractive, given the recent share price decline and 3.0% dividend yield. That said, with the shares still trading at a premium to the U.S. water utility peer group (and above our Buy-rated West coast names, California Water Service Group and American States Water), we maintain our Hold rating and recommend investors wait for a more opportunistic entrance point (more favorable valuation, large accretive acquisition) before considering establishing new positions on the long side.

### East Coast

We now turn our discussion to the water utilities based on the East coast, which include **American Water Works (AWK, \$27.78, Buy)**, **Aqua America (WTR, \$22.48, Buy)**, and **York Water (YORW, \$16.62, Buy)**.

### **Water Supply**

Last September, we did some random checks into surface water supplies across the northeast region and published the results in our Water Works Weekly, dated September 27<sup>th</sup>, 2010. At the time, we visited Aqua America's Pickering Creek facility outside Phoenixville, Pennsylvania, and the Green Lane Reservoir system, which stretches across a wide swath of Montgomery County, Pennsylvania. See below the conditions at the Pickering Creek facility as of September 27<sup>th</sup>, 2010:



Source: BMC research

In a previous check of this facility (May of 2010), we noted water was coming over the top of this facility's dam at such a prolific rate small trees were being carried over into the spillway. At the time of our last report (September, 2010), the dam remained full, but the previous torrent had been reduced to a trickle. In a check on March 20<sup>th</sup>, 2011, we noticed that not only has the flow rate substantially increased over the dam, but the water level overall is significantly higher:



Source: BMC research

Last September, at our check of the Green Lake Reservoir system, we found more troubling signs in terms of future supply. Large areas of reservoir system had completely dried out, to a point where a person could walk for hundreds of yards onto the former reservoir lake bed:



Source: BMC research





Source: BMC research

At the time of that report, we noted that Pennsylvania and New Jersey would need significant precipitation to be able to meet volumes sold in 2010 (for 2011). Since that time, both states have seen significant precipitation, and the Green Lake Reservoir system has returned to a respectable level, as seen below in our recent check there:



Source: BMC research



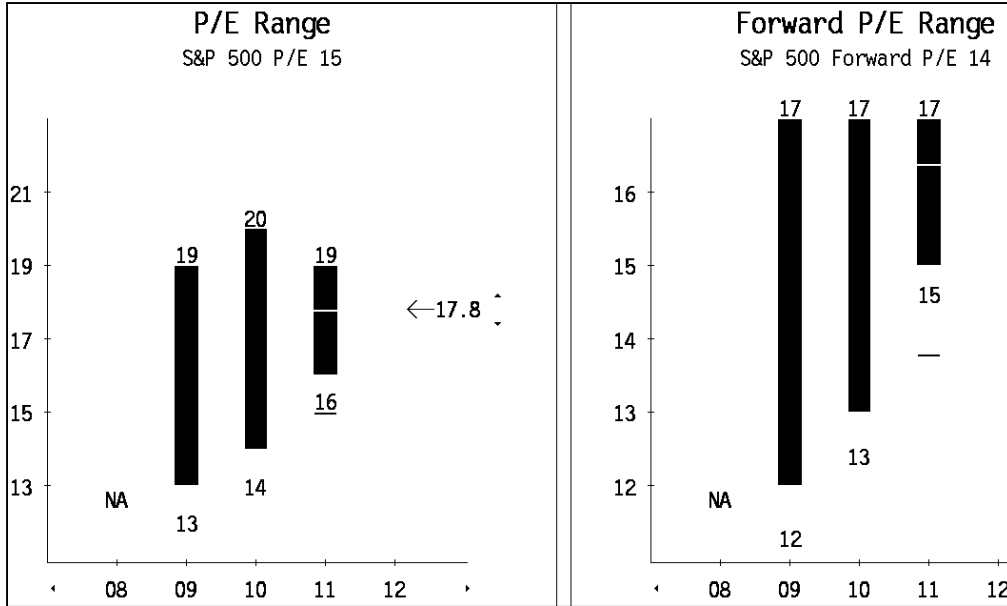
Source: BMC research

We view the plentiful water supply in the region as a positive sign for each of the utilities in the mid-Atlantic area headed into the important summer season. In our view, the lone remaining variable in terms of 2Q11 and 3Q11 performance will be weather; in 2010, the region was warmer than normal in early spring, and conditions remained hot and dry throughout the summer. A similar pattern of weather in 2011 could deliver excellent results for all three East coast-based water utilities in our coverage universe.

**Valuation**

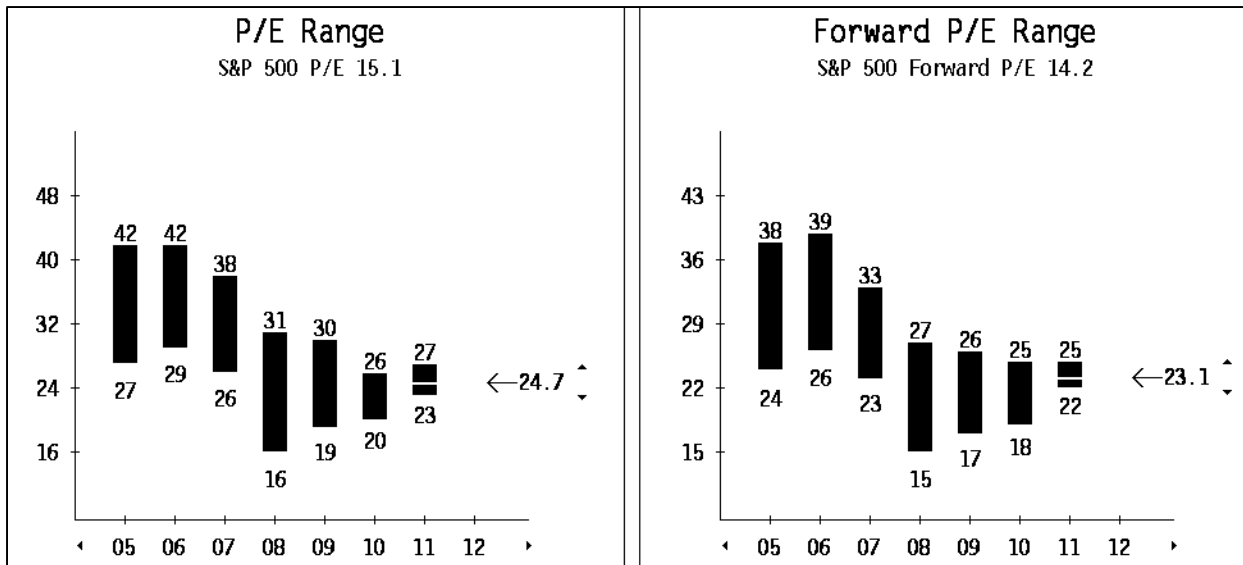
Each of the companies in the mid-Atlantic appears to be trading at a compelling valuation:

**American Water Works Historical Trailing and Forward P/E Ratios, 2008 – 2011**



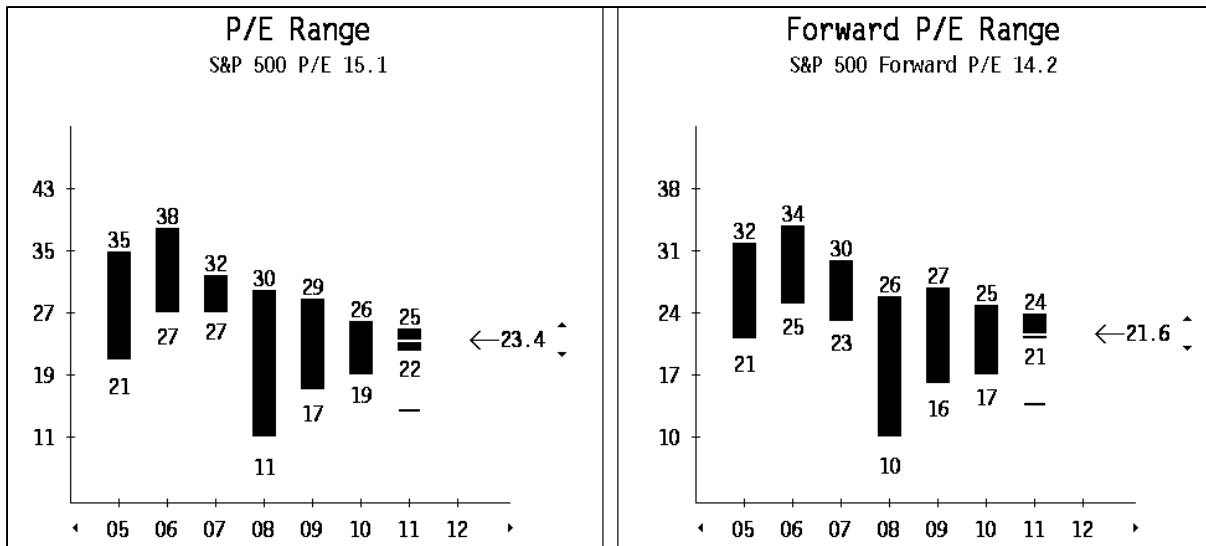
Source: Baseline

**Aqua America Historical Trailing and Forward P/E Ratios, 2005 – 2011**



Source: Baseline

York Water Historical Trailing and Forward P/E Ratios, 2005 – 2011



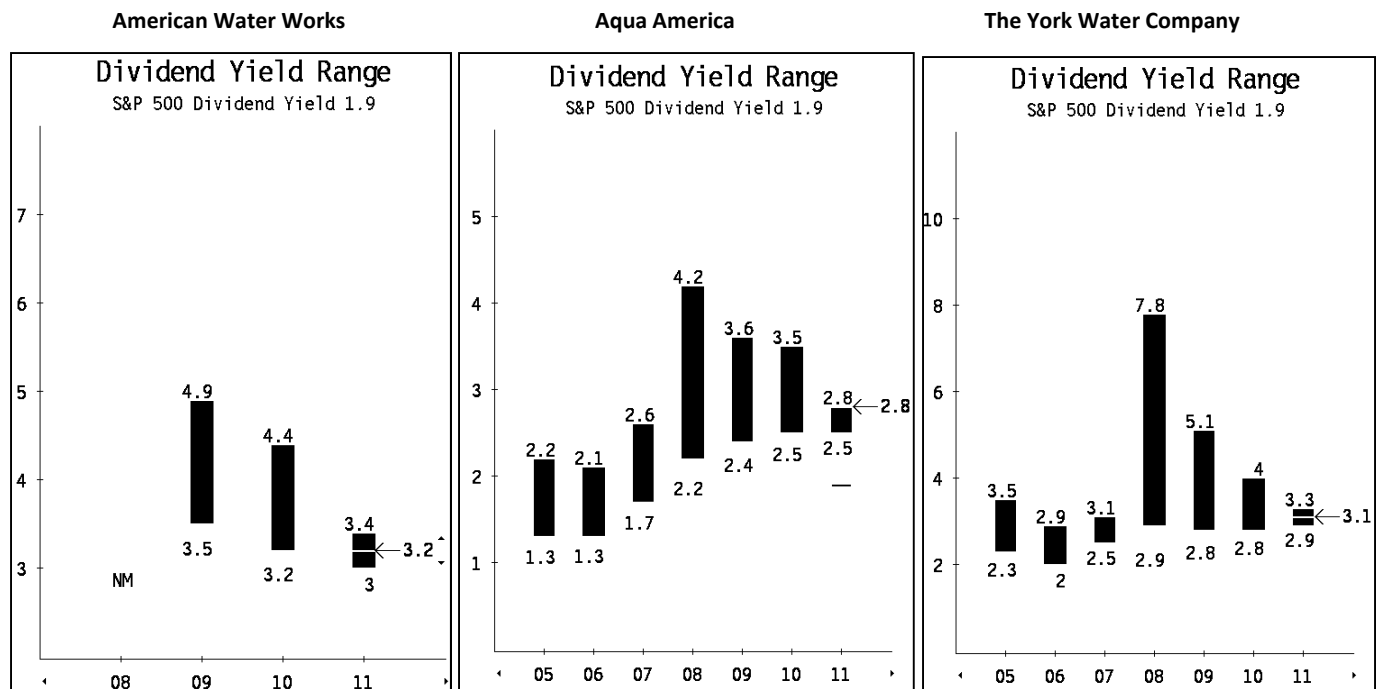
Source: Baseline

A review of the East coast P/E charts indicates that there remains plenty of upside versus historical norms for each of the three names.

Dividend Yields Still Attractive

Just like their West coast peers, East coast water utilities also sport healthy dividends:

East Coast Water Utility Dividend Yields, 2005– 2011 (AWK, WTR, YORW)



Source: Baseline

**Share Price Performance**

Since reporting 4Q10 results, all three names have traded relatively flat. We don't find this surprising, given the upward moves in the share prices in 2010 as favorable rate case awards, water supply and weather all contributed to healthy earnings profiles.

	4Q10 Report Date	Share Price on Report Date	Share Price (03/25/11)	% Change
AWK	2/28/2011	\$27.37	\$27.78	1.5%
WTR	2/24/2011	\$22.40	\$22.48	0.4%
YORW	3/9/2011	\$16.38	\$16.62	1.5%

Source: Baseline

**Outlook for Each Name**

**AWK:** When they reported 4Q10, AWK reaffirmed its previously communicated guidance range of \$1.65 - \$1.75, which implies 8% - 14% EPS growth, a level we view as very obtainable with the initiatives currently underway to rationalize operating assets, reduce costs, and seek higher rates across the company's regulated geographic regions. The shares of AWK continue to offer a generous yield of 3.2%, which sits above the peer group average. Beyond yield, we consider the shares attractive given the current growth profile, driven by operational rationalization, rate case activity, and opportunities to improve the cost structure. Further, the company announced in January that it is selling its assets located in Arizona and New Mexico for \$470 million, which eliminates the need to raise capital this year to support their capex plan of \$800 million - \$1 billion. We maintain our Buy rating and \$35 target price, based on the shares attaining a level of 20x our 2011 EPS estimate of \$1.77.

**WTR:** Aqua reported 4Q10 that essentially matched expectations and declared yet another dividend increase. Looking past the results, we believe WTR is poised for strong future growth. Its ability to access low-cost capital, as well as its strong internal cash generation and proven track record to acquire new systems and invest prudently in its asset base should drive top and bottom line growth on a go-forward basis. With the shares now trading at 23x our 2011 EPS estimate of \$0.98, we continue to recommend accumulation, albeit opportunistically given the close proximity to our share price. We maintain our Buy rating and \$26 target price, based on the shares attaining a level of 27x our 2011 EPS estimate of \$0.98.

**YORW:** When York reported 4Q results, we upgraded the shares to Buy from Hold, given our view that valuation was compelling. Since then the shares have ticked up, but are still at a level that we consider attractive. The company continues to build positive momentum created by robust water supply, rate relief, dividend increases, and forecasted capital expenditure increases. We maintain our Buy rating and \$20 target price, based on the shares attaining a level of 26x our 2011 EPS estimate of \$0.75.

**Top Pick**

Within the U.S. water utility group, American Water Works remains our top pick. AWK's fundamentals continue to improve; its successful track record in filing for timely rate relief and fair treatment by regulators has led to upward earnings revisions and impressive performance in recent quarters. We note AWK shares pay a dividend yield that is above the U.S. water utility peer group average, pays among the highest dividend yields, and has the most upside to our target price (Exhibit 2).

## Exhibit #2

## Water Industry - P/E Ranking, Lowest to Highest, 2011E

Peer Group Analysis		03/26/11		Mkt. Cap	EPS	EPS	EPS	P/E	P/E	P/E	Est LT EPS
Company Name	Ticker	Price	Rating	(MM)	CY09	CY10	CY11E	CY09	CY10	CY11E	Growth
AMER STATES WATER	AWR	\$34.16	BUY	\$630	\$1.62	\$1.91	\$2.11	21.1x	17.9x	16.2x	8.0%
AMERICAN WATER WORKS	AWK	\$27.78	BUY	\$4,842	\$1.24	\$1.54	\$1.67	22.4x	18.0x	16.6x	10.0%
CALIFORNIA WATER	CWT	\$36.10	BUY	\$750	\$1.95	\$1.81	\$2.17	18.5x	19.9x	16.6x	7.0%
YORK WATER CO (THE)	YORW	\$16.62	BUY	\$215	\$0.64	\$0.71	\$0.77	26.0x	23.4x	21.6x	6.0%
SJW	SJW	\$22.65	HOLD	\$422	\$0.81	\$0.93	\$1.00	28.0x	24.4x	22.7x	14.0%
AQUA AMERICA	WTR	\$22.48	BUY	\$3,117	\$0.78	\$0.91	\$0.97	28.8x	24.7x	23.2x	6.0%
<b>Group Average</b>								24.1x	21.4x	19.5x	8.5%

Source: Baseline

## Water Industry - Upside to Target Price

Peer Group Analysis		03/26/11		Mkt. Cap	Current	Target	Target	Price	Price	Target	Upside
Company Name	Ticker	Price	Rating	(MM)	Multiple	Multiple	Multiple	Range	Range	Price	Potential
					CY11	(Low)	(High)	(Low)	(High)		
AMERICAN WATER WORKS	AWK	\$27.78	BUY	\$4,842	16.6x	15.0x	21.0x	\$25.05	\$35.07	\$35.00	26%
CALIFORNIA WATER	CWT	\$36.10	BUY	\$750	16.6x	15.0x	20.0x	\$32.55	\$43.40	\$44.00	22%
YORK WATER CO (THE)	YORW	\$16.62	BUY	\$215	21.6x	19.0x	26.0x	\$14.63	\$20.02	\$20.00	20%
AQUA AMERICA	WTR	\$22.48	BUY	\$3,117	23.2x	20.0x	27.0x	\$19.40	\$26.19	\$26.00	16%
AMER STATES WATER	AWR	\$34.16	BUY	\$630	16.2x	15.0x	20.0x	\$31.65	\$42.20	\$39.00	14%

Sources: Baseline, Brean Murray, Carret &amp; Co.

## Water Industry - Yield

Peer Group Analysis		03/26/11		Mkt. Cap	Yield
Company Name	Ticker	Price	Rating	(MM)	
CALIFORNIA WATER	CWT	\$36.10	BUY	\$750	3.4%
AMERICAN WATER WORKS	AWK	\$27.78	BUY	\$4,842	3.2%
YORK WATER CO (THE)	YORW	\$16.62	BUY	\$215	3.2%
AMER STATES WATER	AWR	\$34.16	BUY	\$630	3.0%
SJW	SJW	\$22.65	HOLD	\$422	3.0%
AQUA AMERICA	WTR	\$22.48	BUY	\$3,117	2.8%

Sources: Baseline, Brean Murray, Carret &amp; Co.

## Important Disclosures

### Ratings and Target Price History

For historical rating and target price information please use the following links:

AWK: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=AWK&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=AWK&analystid=93&re=1&width=500&height=350&wmf=1)

AWR: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=AWR&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=AWR&analystid=93&re=1&width=500&height=350&wmf=1)

CWT: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=CWT&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=CWT&analystid=93&re=1&width=500&height=350&wmf=1)

SJW: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=SJW&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=SJW&analystid=93&re=1&width=500&height=350&wmf=1)

WTR: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=WTR&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=WTR&analystid=93&re=1&width=500&height=350&wmf=1)

YORW: [http://www2.investars.com/cgi-bin/charts/\\_nasdaq.exe?f=1&s=YORW&analystid=93&re=1&width=500&height=350&wmf=1](http://www2.investars.com/cgi-bin/charts/_nasdaq.exe?f=1&s=YORW&analystid=93&re=1&width=500&height=350&wmf=1)

All prices are as of the market close on 3/25/11.

At the time this report was published, Brean Murray, Carret & Co., LLC made a market in the securities of The York Water Company

American Water Works Company, Inc. is, or within the last 12 months has been, a client of Brean Murray, Carret & Co., LLC, and investment banking and/or advisory services are being, or have been provided.

Brean Murray, Carret & Co., LLC has received compensation for investment banking and/or advisory services from American Water Works Company, Inc. within the past 12 months.

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### Brean Murray, Carret & Co. Stock Rating System

Buy - Expected to appreciate by at least 10% within the next 12 months.

Hold - Fully valued, not expected to appreciate or decline materially within the next 12 months.

Sell - Expected to decline by at least 10% within the next 12 months.

	# of Securities	% of Total Securities	# of IB-Related Securities in Past 12 mos.	% of Total Securities
BUY	143	60.34%	17	11.89%
HOLD	61	25.74%	2	3.28%
SELL	6	2.53%	0	0%
NOT RATED	27	11.39%	2	7.41%
<b>TOTAL</b>	<b>237</b>			

Note : Stock price volatility may cause temporary non-alignment of some ratings with some target prices.



## Valuation Methodology and Risks

**American Water Works Co. (AWK):** Our \$35 target price is based on the shares trading at 15x our 2011 EPS estimate of \$1.77. Risks to the achievement of our target price include weather, acquisition integration, regulatory environment, and changes in interest rates.

**American States Water Company (AWR):** Our \$39 target price is based on the shares attaining a level of 18x our 2011 EPS estimate of \$2.15. Risks to the achievement of our target price include integration of acquisitions, weather, environmental regulations, regulation of rates, and interest rates.

**Aqua America (WTR):** \$26 target price, based on the shares attaining a level of 27x our 2011 EPS estimate. Risks to the achievement of our target price include weather, acquisitions, interest rates, environmental / public health responsibilities and regulatory climate.

**California Water Service Group (CWT):** Our target price of \$44, based on the shares attaining a level of 20x our revised 2011 EPS estimate of \$2.18. Risks to the achievement of our target price include integration of acquisitions, weather, environmental regulations, regulation of rates, energy costs and interest rates.

**The York Water Company (YORW):** Our \$20 target price is based on the shares attaining a level of 26x our 2011 EPS estimate of \$0.75. Risks to the achievement of our target price include weather, acquisition integration, regulatory environment and changes in interest rates.

## Analyst Certification

We, Michael Gaugler and Christopher Noon, hereby certify that the views expressed in this research report accurately reflect our personal views about any and all of the subject securities or issuers referred to in this document. The analyst and associate analyst further certify that they have not received and will not be receiving direct or indirect compensation in exchange for expressing the recommendation contained in this publication.

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