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Industry: **WATER INFRASTRUCTURE**

Coverage:

Ticker	Rating	Price
AWK	BUY	\$25.29
AWR	NEUTRAL	\$34.47
CWT	NEUTRAL	\$37.27
PNR	BUY	\$36.51
WTR	NEUTRAL	\$22.48
WTS	NEUTRAL	\$36.59

The Water Rundown

Water Utilities Updates

- AWK Granted Rate Increase in Arizona
- WTR Announces Acquisition in Texas
- ARTNA Files Complaint Against Chester Water

End Market and Industry Updates

- Water Crisis in Northern Ireland
- Mexico, U.S. Agree on Colorado River Allotments
- Ohio Consent Decree will Spur \$3B Infrastructure Program
- Desalination Growth Expected in China

Industry Data and Graphs

- Investment in Water and Sewerage Infrastructure
- Global Water Desalination Capacity

IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.



WATER UTILITIES UPDATES

American Water Granted Rate Increase – AWK (B; TP \$29.00). The Arizona Corporation Commission has approved new rates for six of Arizona American Water's service districts. The ACC approved the increase to fund infrastructure improvements that have been made in the company's two water and four wastewater systems and to offset increases in infrastructure, operational and maintenance costs based on 2008 adjusted information. The first year revenue increase is approximately \$13.1M, but increases due to a phase-in in the second and third years. The total approved ongoing revenue increase for all districts is approximately \$14.7M. We had been modeling a \$12.4M increase associated with the rate case, so the result comes in slightly above our expectations.

Aqua America Announces Acquisition in Texas – WTR (N) has announced that its Texas subsidiary has acquired the water and wastewater system assets of Gray Utility for \$3.3M. The acquisition marks the 23rd acquisition for WTR this year, generally in line with its guided amount for the year. The Gray systems are tuck-ins that serve 6,300 people in three counties located ~40 miles from Houston. WTR appears to remain focused on expanding its presence in fast growth markets, with almost half its acquisitions in FY10 being in the Texas market. We note that the company's operations in Texas accounted for just 8% of revenues in FY09, with the mix expected to increase considerably in the coming years. We believe the acquisition will allow WTR to realize maximum economies of scale in Texas, while further streamlining its rate case filing procedures.

LBR Note: We are encouraged not only by the pace of acquisitions during the most recent fiscal year, but also by managements foresight into entering those markets where it is able to reach critical mass like Texas. Though management has yet to offer its acquisitive growth target for FY11, we expect it 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.

Artesian Resources Files Complaint Against Chester Water – ARTNA (NR) filed a complaint in the U.S. District Court against the Chester Water Authority claiming breach of contract, unjust enrichment and requesting declaratory judgment. Chester Water has agreed to, under an agreement signed with ARTNA in 1997, supply bulk water to ATRNA for treatment and distribution to its customers. ARTNA argues that Chester Water breached the terms of the Agreement by failing to calculate rate increases for the Supplies in 2008, 2009 and 2010. ARTNA is seeking monetary damages, declaratory relief regarding appropriate rates to be paid by unit under terms of agreement

END MARKET & INDUSTRY UPDATES

Water Crisis in Northern Ireland – Northern Ireland's water supply is in a precarious position after the bursting of pipes at three sites had accounted for the loss of more than 2.6M gallons of water per day. As many as 40,000 people have been without water for a number of days after a thaw in icy conditions caused pipes to burst across the country. By most accounts, the situation affecting the UK's only remaining publicly-owned water system and its customers is a disaster of epic proportions, due in large part to a lack of investment in water infrastructure over the years. NI Water, a state-owned company, which is the sole provider of water and sewage services in Northern Ireland, has been warned by the Northern Ireland Secretary of State that there could be major changes in how the NI Water Company is financed. Indeed, NI Water spends less than \$300M annually on water infrastructure improvements, while private companies in the UK and Wales collectively spend more than \$4B annually to maintain healthy water systems. The top officials at NI Water have been called on to resign from their posts, but they have been hesitant to do so, arguing that their main focus at this time is to rectify the problems at hand.

Source: The Daily Mail & The Guardian

LBR Note: Years of neglect and limited investment in water infrastructure has dire consequences, as evidenced by the article above. Indeed, it is evident that the water infrastructure in Northern Ireland has aged well beyond its intended use and is no longer able to withstand the normal freeze-thaw cycle that water systems in most northern climates must deal with. Most water systems in the UK are privately owned and NI Water is one of the few remaining municipally owned systems. While privately owned water systems generally charge their customers the economic cost of services provided, rather than subsidizing the cost of services like many municipalities do, the added revenues are used largely to finance large water infrastructure projects to ensure such catastrophic failures do not occur. While such events are indeed troubling for those affected, we would not be surprised to see additional large-scale failures in the years ahead as many underground pipes in the U.S., as well as abroad, have aged beyond their intended use.



Mexico, U.S. Agree on Colorado River Allotments – U.S. and Mexican officials reached an agreement recently allowing Mexico to defer part of its water allotment from the Colorado River until 2014 while farmers in the Mexicali area repair irrigation networks that were damaged by an earthquake that occurred earlier this year. Under terms of the agreement, Mexico can defer shipment of up to 260K acre-feet of water through 2013, and then subsequently recover that amount in the following three years when construction of the new canals, which will be better suited to handle the load, will be complete. Mexico's annual allotment under a 1944 treaty is 1.5M acre-feet. In addition, the U.S. and Mexico intend to negotiate a full management plan for the Colorado River in 2011 as a result of historic drought conditions in the Colorado River Basin. The reservoirs at the basin have dropped from nearly full levels in 2000 to approximately 55% capacity more recently. If current drought conditions persist, states like Arizona, California and Nevada may be subject to water shortages as early as 2012.

Source: Bloomberg

Ohio Consent Decree will Spur \$3B Infrastructure Program –

A large scale infrastructure program to reduce or treat raw sewage flowing into Cleveland-area waterways and Lake Erie is expected to move forward as a result of a Clean Water Act settlement agreement reached between the U.S. Environmental Protection Agency and the Northeast Ohio Regional Sewer District (NEORS). According to the U.S. government, the NEORS discharged some 5B gallons of untreated, raw sewage 3,000-4,000 times each year into Lake Erie and surrounding waterways. The NEORS was discharging up to 9B gallons of raw sewage in the 1970s. The project, which will attempt to remedy the problem, includes the construction of seven new tunnels and at least \$42M in green infrastructure projects. In addition, the settlement requires the NEORS to spend some \$3B over the next 25 years to install pollution controls, including a number of tunnel systems, which will reduce the discharge of untreated water to just 537M gallons per year. The first \$198M tunnel system contract was bid earlier this year and construction is expected to begin in March 2011. Each tunnel, which will increase the amount of stormwater that can be stored during wet weather events, thereby allowing an increased amount of wastewater to be treated, will be bid separately over the course of a number of years. The settlement is subject to a 30-day public comment period and final court approval.

Source: Engineering News-Record

LBR Note: EPA enforcement is the primary driver for investment by municipalities and commercial/industrial establishments to limit their pollutant discharge. Circumstantial evidence suggests that the EPA has, in the last year, increased the level at which it issues consent decrees to local municipalities, including many large systems, as the above article suggests. This could be a long-term positive for companies like WTS,

PNR and MWA, all of which rely upon, to a certain degree, spending by state and local government on water system repairs.

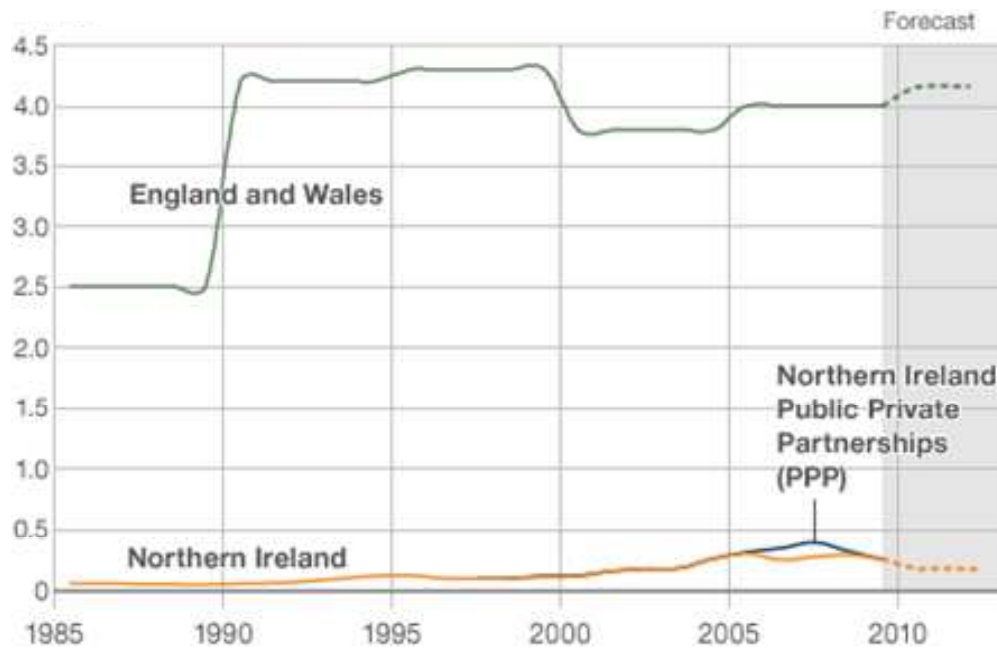
Desalination Growth Expected in China – Despite billions spent on damming rivers, expanding reservoirs and digging new wells, hundreds of cities across mainland China will face water shortages and deteriorating water quality in the coming years. Indeed, Beijing's water shortage will soon reach 200-300M cubic meters as the city awaits the completion of the \$62B South-North Water Transfer Project, which will displace some 330,000 people. Such water shortages are affecting numerous cities across the country where such large-scale water projects may not be feasible in form or function. As a result, China has become increasingly focused on implementing desalination technology in an attempt to bridge the gap between the countries needs and its production capacity. As a result of China's newfound interest in the technology, the country's desalination capacity reached nearly 200K tons per day in 2008, up from just 30K in 2005. According to the government's current development plan, the figure is expected to reach 800K to 1M million tons by the end of this year. The government, aside from investing in technology, has taken a greater interest in promoting water conservation, as well. In 2007 China issued its eleventh five-year plan for water conservation, proposing detailed targets, including increasing the agricultural water conservation rate to 50% from 45% between 2005 and 2010. In addition, A new report by Pike Research, an industry research firm, predicts that the global installed capacity of desalination projects will grow by about 55M cubic meters per day (m3/d) during the period between 2010 and 2015. About 54% of that growth will occur in the Middle East and North Africa, with a large portion occurring in Asia, as well.

Source: IPS News

LBR Note: PNR (B; TP \$39.00) remains focused on expanding its presence in Asia and the Middle East. Limited investment in the last decade, coupled with increasing demand and greater per capita income, suggests that there is indeed a high level of pent-up demand in the region. China, in particular, accounts for less than 3% of overall sales (or \$90M), and is expected to increase to 6% of total sales by 2014 through new product offerings and deeper channel penetration. The company recently noted that just one point of market share gain in APAC would result in 12-15% of segment growth, or \$50M.

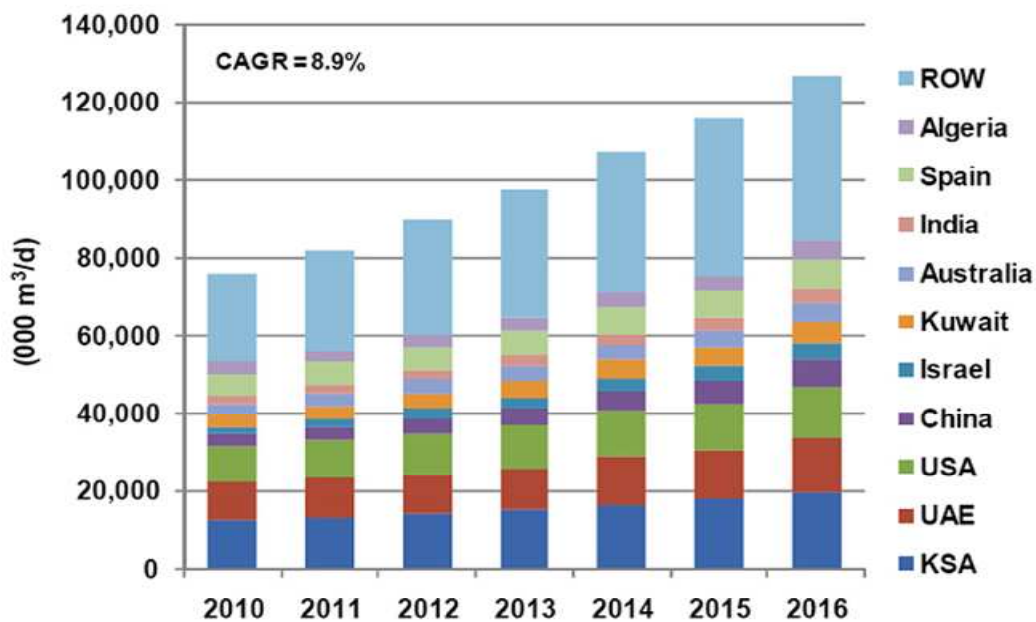


Investment in Water and Sewerage Infrastructure (£ in billions)



Source: NI Water Draft Determination Response 2009

Global Water Desalination Capacity (2010-16)



Source: Pike Research



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			\$34.47	\$39.61	\$31.20	\$ 642	\$ 361	1.62	1.78	2.15	19.4x	16.1x	3.0%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	15%	\$25.29	\$25.82	\$19.41	\$ 4,423	\$ 2,841	1.25	1.55	1.70	16.3x	14.8x	3.5%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$22.48	\$22.97	\$16.45	\$ 3,092	\$ 671	0.77	0.92	1.00	24.3x	22.5x	2.8%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$37.27	\$39.70	\$33.81	\$ 776	\$ 449	1.95	1.91	2.20	19.5x	17.0x	3.2%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$18.95	\$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			\$27.88	\$27.90	\$20.00	\$ 241	\$ 59	1.19	1.2	1.19	23.2x	23.4x	3.3%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$18.35	\$19.31	\$14.74	\$ 285	\$ 91	0.72	0.94	0.95	19.5x	19.3x	4.0%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$27.36	\$28.39	\$19.00	\$ 128	\$ 33	0.55	0.84	0.95	32.6x	28.8x	2.7%	1.8x
SIW	SIW	Dec.	NR			\$26.47	\$28.24	\$21.60	\$ 491	\$ 216	0.81	0.98	1.06	27.0x	25.0x	2.6%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$17.29	\$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%	\$36.51	\$39.32	\$29.41	\$ 3,603	\$ 2,692	1.47	1.96	2.28	18.6x	16.0x	2.1%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$36.59	\$37.41	\$27.51	\$ 1,355	\$ 1,234	1.54	1.92	2.23	19.1x	16.4x	1.2%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$76.37	\$85.25	\$55.42	\$ 706	\$ 547	3.05	2.90	3.84	26.3x	19.9x	1.6%	1.1x
BADGER METER	BMI	Dec.	NR			\$44.22	\$45.49	\$32.58	\$ 665	\$ 250	1.80	1.91	2.08	23.2x	21.3x	1.3%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$15.12	\$18.35	\$11.75	\$ 852	\$ 412	0.69	0.68	0.86	22.2x	17.6x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.66	\$7.25	\$3.08	\$ 192	\$ 47	0.07	(0.08)	-	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$38.92	\$41.79	\$24.93	\$ 903	\$ 626	1.29	1.86	2.26	20.9x	17.2x	1.3%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$32.32	\$37.40	\$22.81	\$ 543	\$ 266	1.15	1.34	1.6	24.1x	20.2x	1.3%	2.6x
ITRON	ITRI	Dec.	NR			\$55.45	\$81.95	\$52.03	\$ 2,241	\$ 1,687	2.09	4.02	4.33	13.8x	12.8x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$34.42	\$36.92	\$22.97	\$ 674	\$ 866	0.81	1.42	1.67	24.2x	20.6x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$4.17	\$5.99	\$2.21	\$ 646	\$ 1,338	-0.29	(0.17)	0.15	NM	NM	1.7%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$24.03	\$29.19	\$14.62	\$ 223	\$ 283	-0.26	0.12	0.73	200.3x	32.9x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$49.58	\$51.01	\$31.84	\$ 5,711	\$ 2,402	1.77	2.50	2.5	19.8x	19.8x	1.3%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$38.08	\$45.80	\$27.39	\$ 1,745	\$ 1,991	1.90	2.70	2.91	14.1x	13.1x	1.5%	1.7x
Average														45.3x	19.5x	0.8%	2.0x
WATER RESOURCES/ INFRASTRUCTURE																	
INSITUFORM TECH	INSU	Dec.	NR			\$26.51	\$28.52	\$18.52	\$ 1,040	\$ 727	1.04	1.52	1.78	17.4x	14.9x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$59.43	\$72.80	\$30.80	\$ 744	\$ 358	1.11	1.68	2.21	32.5x	27.4x	0.6%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$25.06	\$28.18	\$18.00	\$ 1,548	\$ 2,201	1.22	1.25	1.43	20.5x	18.2x	0.0%	1.7x
Average														24.9x	18.8x	0.7%	2.1x
Relevant Indices						Share Price											
Dow Jones Industrials						DJ30		\$11,578									
S&P 500						SPX		\$1,258									
Nasdaq Composite						NDX		\$2,218									

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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