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Industry: **WATER INFRASTRUCTURE**

Coverage:

<b>Ticker</b>	<b>Rating</b>	<b>Price</b>
AWK	BUY	\$25.93
AWR	NEUTRAL	\$34.52
CWT	NEUTRAL	\$37.50
PNR	BUY	\$35.82
WTR	NEUTRAL	\$23.17
WTS	NEUTRAL	\$35.66

## The Water Rundown

### Water Utilities Survey

#### Water Utilities Updates

- AWK to Divest Southwest Assets
- ARTNA Under Investigation

#### Water Infrastructure Updates

- AMN to Construct New Plant to Service Transportation Market
- CCC Discloses Negotiations with the EPA
- ITRI Raises its Multicurrency Line of Credit

#### End Market and Industry Updates

- China to Spend \$303B on Water Projects
- GOP Assemblyman Proposes 25% Cut in CA Water Bond
- U.S. Infrastructure in Trouble, Experts Says

#### Industry Data and Graphs

- Newark, New Jersey Water Consumption
- Dallas, Texas Water Consumption
- Austin, Texas Water Consumption
- Los Angeles, California Water Consumption

**IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.**



## WATER UTILITY SURVEY

In our survey we spoke to officials at municipal water systems across the country as well as received monthly consumption data through November/December from Newark, Philadelphia, Pittsburgh, Dallas, Austin, San Antonio, Santa Fe, Los Angeles, Naperville, IL (Chicago suburb), Fort Wayne, IN, and Cleveland Departments of Water. We also collected publicly available data from various municipalities regarding actual water consumption. Our takeaways are based on a compiled mosaic of these survey responses and acquired data points, including our analytical interpretation of investment implications. For a more detailed analysis, see our article titled *Water Utilities: Water Consumption Trends Better Than Expected* published on January 19, 2010.

### New Jersey

According to data collected in Newark, NJ demand has declined marginally in recent months from the comparable period last year. Demand in December slipped 0.2% y/y, while usage declined a more notable 6% y/y in November. 4Q10 demand appears to have declined nearly 3% from the year ago period, compared to the 5% y/y increase reported in 3Q10. The decline may be partially attributable to above-normal precipitation in recent months. According to our survey contacts throughout the state, demand decreased, on average, by 6% y/y.

### Pennsylvania

Demand trends across Pennsylvania varied by geography, with the areas surrounding Philadelphia showing relative weakness. In November, demand in Philadelphia declined 8% y/y. Likewise, demand in Pittsburgh declined 7% y/y in November and is nearly 15% below the historical 5-year average. Quarter-to-date demand in Pittsburgh is down 6% from the year ago period.

### Texas and Southwest

Quarter-to-date demand in Dallas is up 16% from the comparable period last year. The seasonal m/m decline of 13% was considerably more muted than the last four years, when demand typically declined between 25-37% m/m. All end user segments posted notable y/y gains, with the exception of the more volatile municipal segment, which declined 57% y/y. We note that the municipal segment typically accounts for only 1-3% of total water volume sold. Residential demand led the advance, increasing 54% y/y. Industrial demand increased 2% m/m, reversing the historical trend of low-single digit m/m declines. Likewise, y/y demand surged 37% as compared to historical declines in the mid-single digits. Commercial increased 21% y/y, but declined 10% m/m, in line with historical trends. In general, improving economic trends in the Dallas market, along with easier y/y comparisons due to usually wet weather during the comparable period last year led to the outperformance.

In Austin, a market that witnessed greater declines in water consumption than Dallas due to water conservation measures, reported its first y/y increase in demand since August 2009. Total demand in November increased 25% y/y, with all end markets reporting strong y/y gains. Quarter-to-date volumes are up 16% from the year ago period. Residential and commercial usage, which account for a combined 70% of overall demand, surged 36% and 27% compared to the same period last year, respectively. On a m/m basis, residential usage increased a modest 2.8%, while commercial usage slipped 5.5%. Multifamily usage increased slipped 8% m/m, but increased 7% y/y. Usage by manufacturers (large volume) declined 9% m/m and was flat vs. the comparable period last year. Lastly, demand for wholesale bulk water by surrounding cities surged 50% y/y. We note that improving economic trends in Austin, along with easier y/y comparisons due to usually wet weather during the comparable period last year led to the outperformance.

In San Antonio, demand increased 1% m/m and 14% y/y in December. 4Q10 demand appears to have jumped nearly 10% from the year ago period, compared to the 5% y/y increase reported in 3Q10. As with the aforementioned cities in Texas, the uptick in water consumption is largely attributable to easier y/y comparisons due to wet weather during the comparable period last year.

Our survey contacts in Texas reported that demand increased, on average, 11% y/y, generally in line with the data we collected from the various municipalities. *“November was a very active month for us in terms of water volume sold. Usage for the month was up almost 15% from a year ago, mostly because the weather at that time wasn't very good. Variability in pumpage has been fairly noticeable this year - more so than in years past,”* reported one contact in Texas.

In Santa Fe, NM demand trends have been variable during much of 2010. Total demand in October and November was flat both y/y. Likewise, quarter-to-date volumes were largely stable.



### Los Angeles

In Los Angeles and more broadly in California, water consumption remains at historically low levels and in most instances continues to decline in the low-to-mid single digits. Quarter-to-date demand in LA is largely stable compared to the year ago period. The continued decline in some areas throughout the state comes as no surprise given foreclosure activity, economic concerns, increased conservation efforts, and recent storm activity in November/December. All together, based on the water usage statistic collected from the Los Angeles Department of Water, total demand in November declined 2.2% y/y. Demand increased 1.3% y/y in October. As a reminder, August marked the first positive y/y comparison in 17 months (1Q09) when demand increased a meager 0.8% y/y. Demand stemming from the highly variable industrial end market (6% of sales) surged 44% y/y after declining 23% y/y during the previous month. All of the remaining end market segments posted declines in the low-to-mid single digits. Indeed, single-family consumption dropped 3.2% y/y, while multifamily consumption declined 4.8% y/y. Likewise, both commercial and municipal (schools, courts, etc) consumption declined 4.3% y/y. We note that single-family and multifamily usage accounted for a combined 71% of sales.

Our contacts throughout California reported that consumption declined, on average, 6%. Inclement weather in December, along with conservation efforts were viewed as the main drivers of the decline, according to our contacts. Again, we note that since the implementation of WRAM and MCBA in California, revenues and costs have been decoupled from water consumption and therefore direct consumption trends are less impactful on reported quarterly results.

### Indiana and Illinois

In Fort Wayne, water consumption increased 8.9% m/m and 2.7% y/y. Demand in CY 4Q10 increased 3% from the comparable period last year. Below-normal precipitation may have played a part in the y/y increase in consumption. We note that WTR has a number of water systems in the suburbs surrounding Fort Wayne.

The data we collected from the Naperville, IL Department of Water generally supports our contacts responses. In Naperville, water consumption increased a modest 0.4% in November, but was up more than 20% in October due to easy y/y comparisons. Quarter-to-date volumes are up 10% from the comparable period last year.

Anecdotal demand in the Midwest, according to our contacts, demand increased, on average, 9% in November from the comparable period last year. Most contacts noted that the increase in consumption was largely due to weather related activity.

### Ohio

Demand in CY 4Q10 increased 5% from the comparable period last year. The y/y increase is a result of near-normal precipitation levels in recent months, whereas the state witnessed above-normal precipitation levels last year, resulting in a decline in water consumption levels. Broadly improving economic conditions were also credited for the resurgence in water consumption. We note the majority of WTR's facilities in Ohio (7% of sales) are in the suburbs surrounding Cleveland.

### Notable Quotes

- “For last year, for the month of November, we sold 204M gallons, whereas this year we were up a little bit and did 218M gallons. We didn't add or lose many connections, so it's probably just associated with the weather more than anything else.”  
– *Municipal Water System, IL*
- “The pumpage for the city in 2009 was 91.45MG and this year it was 79.45 MG, a 13% decline. The decline was due to a loss of a few large commercial connections, as well as just an overall decline in consumption.” – *Municipal Water System, NJ*
- “November was a very active month for us in terms of water volume sold. Usage for the month was up almost 15% from a year ago, mostly because the weather at that time wasn't very good. Variability in pumpage has been fairly noticeable this year - more so than in years past.” – *Municipal Water System, TX*



## WATER UTILITIES UPDATES

**AWK Divests Southwest Assets** - AWK (BUY-\$29 PT) that it has entered into an agreement with EPCOR Water to sell its water and wastewater assets located in Arizona and New Mexico for \$470M. To date, AWK has invested \$450M in its AZ and NM subsidiaries and the deal was, according to the company, at a 14% premium to the book value of equity. The deal is expected to close in 2012 pending regulatory approval. In that the company's capital structure has become a growing concern, the asset sale is expected to mitigate the need for an equity issuance in FY11. Prior to the asset sale, we had estimated that AWK would need to issue ~\$450M in equity in order to achieve a 45% debt-to-capital ratio vs. the 42% currently. Also, management noted that its five-year, \$800-1B capex program remains intact despite the asset sale. In that the capital will be deployed over a smaller portfolio of water and wastewater systems, presumably those that generate more attractive ROEs, we expect potential upside to the company's long term 7-10% annual EPS growth forecast despite the smaller asset base.

**Artesian Resources Under Investigation** - ARTNA (NR) announced that it has received a federal grand jury subpoena in connection with an investigation being conducted by the U.S. Attorney's Office and the Environmental Protection Agency (EPA). The company reported that the subpoena requests certain documents relating to eight wastewater facilities in Pennsylvania that were formerly operated by personnel of Artesian Utility Development, Inc, a wholly owned subsidiary. Though the company did not offer any additional information beyond what was issued in the press release, it noted that it is fully cooperating with the investigation.

## WATER INFRASTRUCTURE UPDATES

**Ameron to Construct New Plant to Service Transportation Market** - AMN (NR) announced that it plans to construct a new steel pole plant in Oklahoma. The 75K sq. ft. facility is expected to cost \$35M and should be operational within two years. When fully operational, the facility will have annual sales capacity of up to \$75M. The broad range of products to be produced at the facility include highway lighting, traffic signal control structures, light rail, high mast and smart grid structures, and highway signage. The company is excited about entering the national transportation infrastructure market due to long-term and steady growth thanks to federal and state funding.

**Calgon Carbon Discloses Negotiations with the EPA** - CCC (NR) has announced that it is in negotiations with the U.S. Department of Justice (DOJ) and the Environmental Protection Agency (EPA) to attempt to settle previously disclosed environmental enforcement matters involving the company's Big Sandy Plant in Catlettsburg, Kentucky. The company has already accrued \$1M for possible monetary fines that may arise from the proceedings. The company noted that if the resolution includes both modifications and remediation of its facility, then process changes to the plant will be required, with capital costs exceeding \$10M in such an instance. If the company is not successful in negotiating a settlement, the DOJ has announced that it will bring a civil complaint against CCC, with the company noting that it will defend itself against the action.

**Itron Raises its Multicurrency Line of Credit** - ITRI (NR) announced that it has increased its \$240M multicurrency revolving line of credit to \$315M. No other changes were made to the credit facility. The expanded multicurrency revolving line of credit will be used for general corporate purposes.

## END MARKET & INDUSTRY UPDATES

**China to Spend \$303B on Water Projects** - China has announced that it will invest \$303.8B over the next five years to build water-related infrastructure and improve water quality in rural areas. The sizable investment comes after severe flooding and droughts last year destroyed crops and drove up food prices. As a result, the government expects to spend \$3B in 2011 alone to "push forward construction of key projects." By the end of 2011, the government estimates that 77% of the country's rural residents will have access to safe drinking water. The country has already spent over \$100B in the past five years on its water infrastructure.

*Source: Reuters*

**GOP Assemblyman Proposes 25% Cut in CA Water Bond** - Kevin Jeffries, a California Assembly member, has introduced legislation to significantly reduce the size of a water bond that would help pay for upgrading the state's water infrastructure. The assemblyman has proposed cutting the \$11B bond by 25%, reducing it to just \$8.25B. The initiative was originally scheduled to be placed on the ballot in 2010, but has since been rescheduled to be on the November 2012 ballot due to concerns about its chances of passing the 2010 polls. Jeffries, who strongly supports the initiative, believes that a smaller price tag is needed to win voter approval.

*Source: SF Gate*

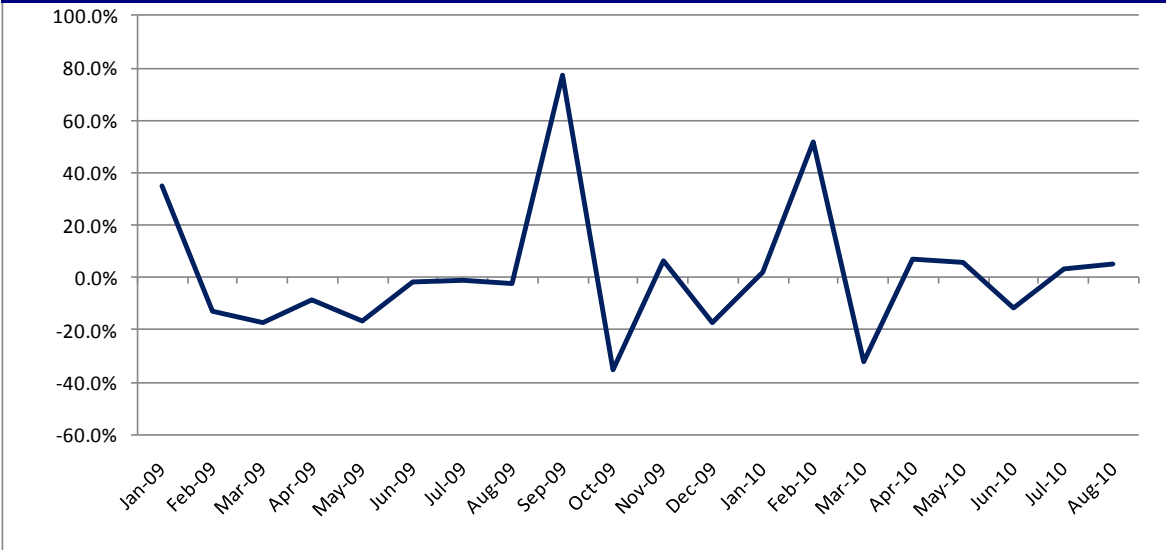


**U.S. Infrastructure in Trouble, say Experts** – The nation's drinking water network is troubled, so troubled in fact that the American Society of Civil Engineers gave it a grade of D minus in its 2009 Report Card of America's Infrastructure. The poor mark came as a result of a number of shocking statistics about the state of our present water infrastructure network, much of which is a result of the broader system's average age. To put it in perspective, some 30% of pipes in systems that deliver water to more than 100,000 people are between 40 and 80 years old, while 10% of pipes in those systems are even older than that. In that much of the nation's underground water infrastructure has aged beyond its intended use, water main breaks and leaking pipes have become more prevalent in recent years. Indeed, it is estimated that there are more than 240,000 water main breaks each year, with some 7B gallons of water wasted daily due to leaking pipes. In most instances, these problems are swept under the rug as municipalities are unable to shoulder the considerable financial burden of upgrading our nation's water infrastructure. To be sure, according to the EPA, the estimated price tag for repairing the nation's water infrastructure rises after every year of neglect, with their most recent estimate pointing to \$335B in funds needed to fully repair the nation's crumbling infrastructure. Nevertheless, funding for such infrastructure projects is limited to internally generated funds by municipalities and bond offerings, rather than direct federal investment. As a result, infrastructure investment is expected to remain retroactive, with upgrades coming only as underground pipes and systems fail.

*Source: CNN*

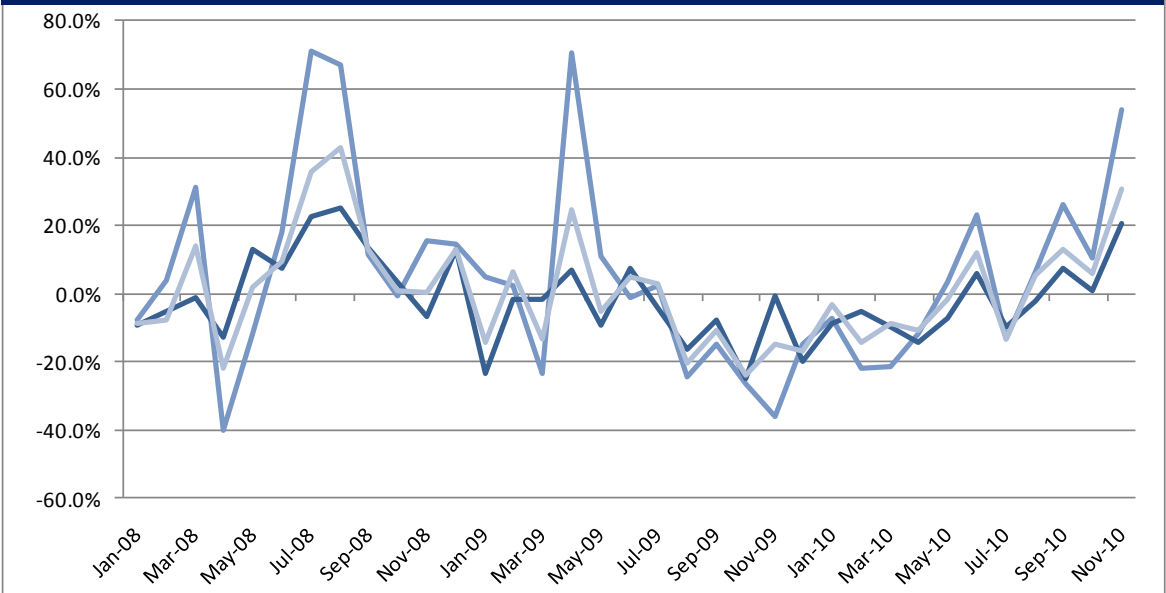


### Newark, New Jersey - % Change in Total Water Consumption



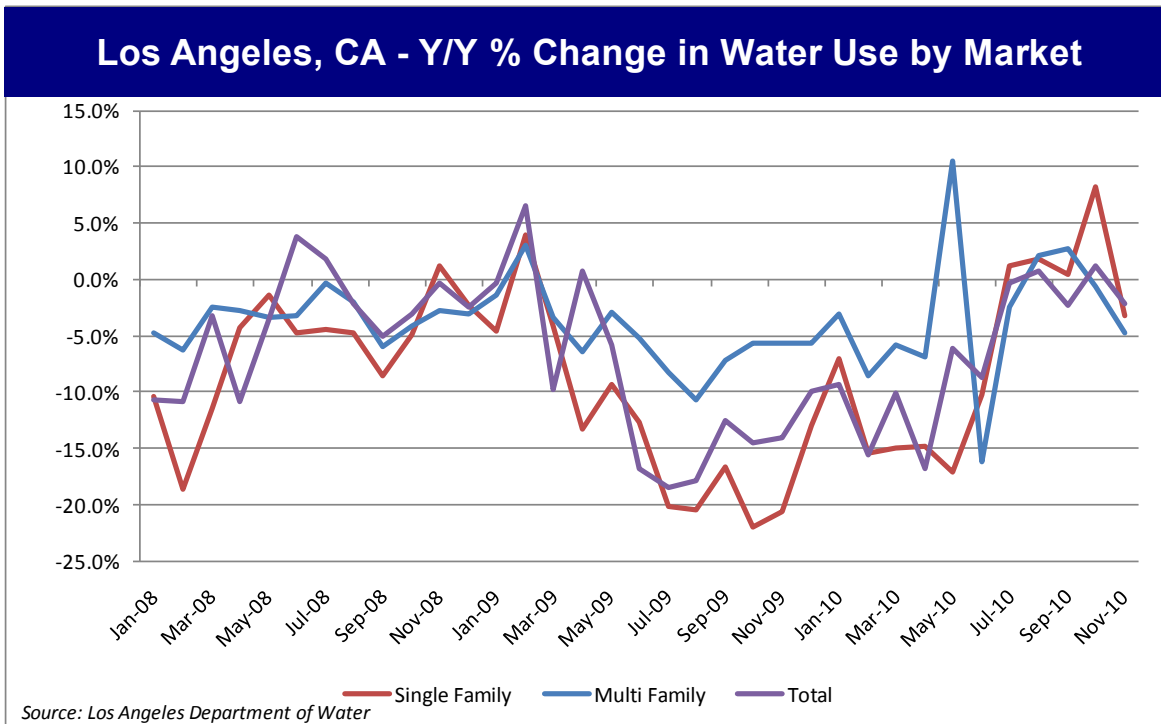
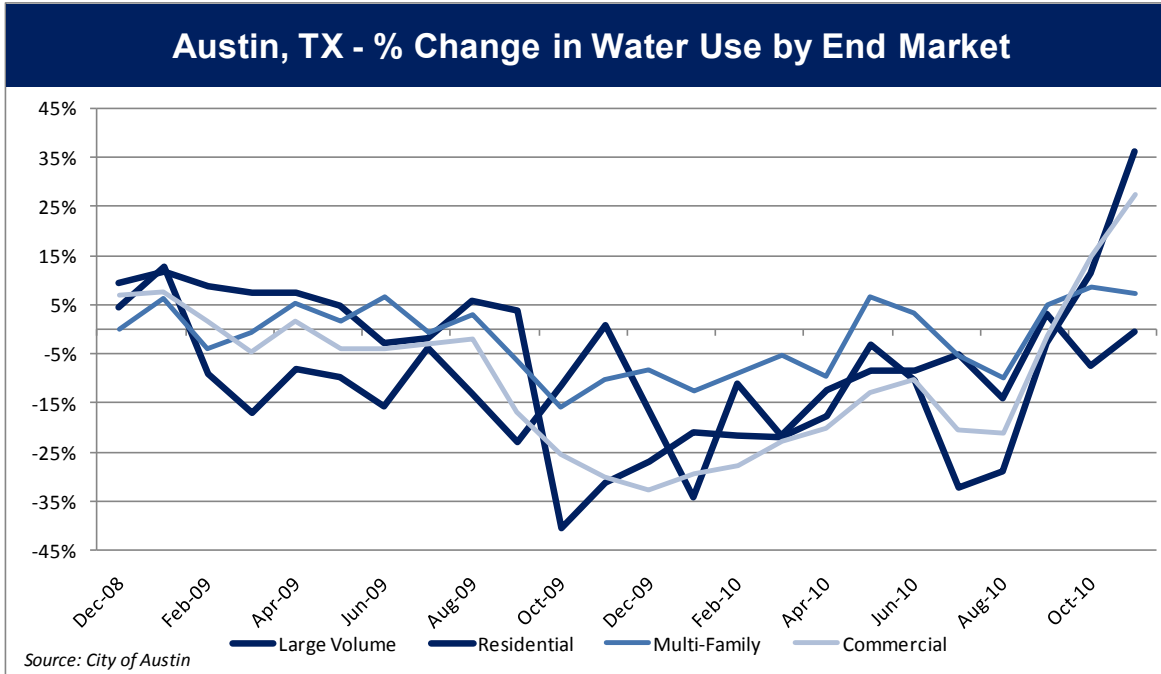
Source: City of Newark

### Dallas, TX - Y/Y % Change in Water Use



Source: Dallas Department of Water

Residential Commercial Total



**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			\$34.18	\$39.61	\$31.20	\$ 636	\$ 361	1.62	1.78	2.15	19.2x	15.9x	3.0%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	13%	\$25.59	\$25.99	\$19.41	\$ 4,475	\$ 2,849	1.25	1.58	1.72	16.2x	14.9x	3.4%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$23.04	\$23.48	\$16.45	\$ 3,169	\$ 671	0.77	0.93	1.00	24.7x	23.1x	2.7%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$37.26	\$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			\$19.29	\$19.63	\$16.43	\$ 146	\$ 61	0.97	1.02	1.11	18.9x	17.4x	3.9%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$24.88	\$28.27	\$20.00	\$ 215	\$ 59	1.19	1.2	1.20	20.7x	20.7x	3.7%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$17.79	\$19.31	\$14.74	\$ 277	\$ 91	0.72	0.94	0.95	18.9x	18.7x	4.1%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$27.95	\$28.39	\$19.00	\$ 130	\$ 33	0.55	0.84	0.95	33.3x	29.4x	2.6%	1.8x
SIW	SIW	Dec.	NR			\$24.55	\$28.24	\$21.60	\$ 455	\$ 216	0.81	0.98	1.06	25.1x	23.2x	2.8%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$16.11	\$18.00	\$12.83	\$ 204	\$ 37	0.64	0.71	0.76	22.7x	21.2x	3.3%	2.1x
Average														21.9x	20.2x	3.3%	1.7x
<b>EQUIPMENT/ FILTRATION/ TREATMENT SECTOR</b>																	
PENTAIR	PNR	Dec.	BUY	\$39	10%	\$35.57	\$39.32	\$29.41	\$ 3,510	\$ 2,692	1.47	1.96	2.28	18.1x	15.6x	2.2%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$35.06	\$37.79	\$27.51	\$ 1,298	\$ 1,234	1.54	1.92	2.23	18.3x	15.7x	1.3%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$73.19	\$85.25	\$55.42	\$ 677	\$ 547	3.05	2.90	3.84	25.2x	19.1x	1.6%	1.1x
BADGER METER	BMI	Dec.	NR			\$39.90	\$45.49	\$32.58	\$ 600	\$ 250	1.80	1.91	2.07	20.9x	19.3x	1.4%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$13.97	\$18.35	\$11.75	\$ 787	\$ 412	0.69	0.68	0.86	20.5x	16.2x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.60	\$6.77	\$3.08	\$ 189	\$ 47	0.07	(0.08)	-	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$42.25	\$43.21	\$24.93	\$ 981	\$ 626	1.29	1.86	2.29	22.7x	18.4x	1.2%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$31.05	\$37.40	\$22.81	\$ 521	\$ 266	1.15	1.34	1.6	23.2x	19.4x	1.4%	2.6x
ITRON	ITRI	Dec.	NR			\$58.63	\$81.95	\$52.03	\$ 2,369	\$ 1,687	2.09	4.02	4.33	14.6x	13.5x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$30.73	\$36.92	\$22.97	\$ 601	\$ 866	0.81	1.42	1.63	21.6x	18.9x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$4.06	\$5.99	\$2.21	\$ 629	\$ 1,338	-0.29	(0.17)	0.15	NM	NM	1.7%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$21.27	\$25.50	\$14.62	\$ 198	\$ 283	-0.26	0.12	0.73	177.3x	29.1x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$48.84	\$51.16	\$31.84	\$ 5,626	\$ 2,402	1.77	2.50	2.5	19.5x	19.5x	1.4%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$39.46	\$45.80	\$27.39	\$ 1,808	\$ 1,991	1.90	2.70	2.91	14.6x	13.6x	1.4%	1.7x
Average														41.9x	18.9x	0.8%	2.0x
<b>WATER RESOURCES/ INFRASTRUCTURE</b>																	
INSITUFORM TECH	INSU	Dec.	NR			\$26.60	\$29.17	\$18.52	\$ 1,043	\$ 727	1.04	1.52	1.80	17.5x	14.8x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$62.81	\$72.80	\$30.80	\$ 787	\$ 358	1.11	1.68	2.22	34.3x	28.7x	0.5%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$23.95	\$27.16	\$18.00	\$ 1,479	\$ 2,201	1.22	1.25	1.43	19.6x	17.4x	0.0%	1.7x
Average														24.6x	18.8x	0.7%	2.1x
<b>Relevant Indices</b>						<b>Share Price</b>											
Dow Jones Industrials		DJ30				\$11,872											
S&P 500		SPX				\$1,283											
Nasdaq Composite		NDX				\$2,268											

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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period.

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“Sell” means that Longbow Securities expects total return to be negative by greater than 20% over a 12-month period.

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