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Industry: **WATER INFRASTRUCTURE**

Coverage:

Ticker	Rating	Price
AWK	BUY	\$26.73
AWR	NEUTRAL	\$33.60
CWT	NEUTRAL	\$35.67
PNR	BUY	\$38.18
WTR	NEUTRAL	\$23.41
WTS	NEUTRAL	\$37.36

The Water Rundown

PNR Earnings Recap

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IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.



PNR EARNINGS RECAP

Pentair (PNR, BUY, \$41PT) reported 4Q10 of \$0.49 vs. consensus of \$0.47 and guidance \$0.42-0.47. Sales trends during the quarter were better than we expected, up 7% y/ as most business units within water moderately exceeded our expectations. Consolidated incremental margins of 5%, which were below the company's long run target of 35-40%, but were largely inline as better sales offset rising material cost inflation and no significant price increases realized during the quarter.

Water: Water segment sales grew 5% y/y. Geographically, sales in the U.S. increased 7% y/y thanks to strong sales in the municipal pump (due to GIWW) and agriculture markets. Sales grew 16% in fast growth regions, with sales in China increasing 42%, supported by double digit increases in India and Southeast Asia. Within the water segment, pool sales were up 4%, residential flow was up 1%, engineered flow was up 20%, residential filtration increased 1%, and filtration solutions (commercial and municipal) increased 9%. Margins of 11% were down 60bps from the prior year period, largely due to a negative 240bps impact from raw material cost inflation, which was only modestly offset by growth (+120bps) and productivity gains (+60bps). That being said, the company noted that margin performance was better than expected due in large part to sequential improvements in productivity and the price/material mix. Also worth mentioning is that the Pool GBU added 50 distributors during the quarter, bringing the total additional distributor capacity during FY10 to 350, which allows for greater market penetration and should intuitively lead to greater sales going forward.

Technical Products: Technical product sales increased 11% y/y, with average daily sales up sequentially despite four fewer selling days during the quarter. Most of the company's major end markets displayed considerable strength during the quarter, led by energy (+29% y/y), general electronics (+25%) and commercial (+7%), while communications declined 6% y/y due to timing issues. The segments largest end market, industrial, increased 18% y/y. On a regional basis, U.S. sales increased 11% y/y, while fast growth regions were up 32%, led by growth of 57% in China. In FY10, sales in China increased 45% from the year ago period. Margins of 15% were just below our 15.2% forecast and generally in line with management's expectations. Growth (+200bps) and productivity (+80bps) only partially offset material inflation, reinstated employee benefits, as well as channel rebates, which negatively impacted margins by 310bps.

Raw Material Cost Inflation Likely Offset by Higher Prices: Management reminded investors that it recently implemented a number of price increases across all of its product lines, the benefits of which will be fully realized in 2Q11, which it expects to yield a benefit of 150-200bps for the full year. By segment, management expects Technical Products to be at the high end of that range, while the Water segment is expected to vary, with some GBU's being at the lower end, while others are expected to come in north of the range. Furthermore, the company now expects material inflation to be 3-3.2% of sales, compared to its previous guidance of 2.5% of sales during its December FY11 outlook conference call. That being said, the company has positioned its GBU's to expect raw material cost inflation of 3.5-3.6% of sales, thereby affording the company a moderate degree of headroom if cost inflation persists. We believe that net neutral pricing along with improved demand will result in a resumption of margin expansion in FY11 during which we are modeling ~120 bps in improved margins.

Margin Expansion Expected to Continue As Volumes Grow: Company-wide margins are expected to expand ~100bps in FY11 to ~12%, which is in line with the company's 2014 goal of 100bps in annual margin improvement. To get there, the company expects a 50bps improvement stemming from labor productivity and another 50bps improvement from overhead management. Water margins are expected to expand by at least 100bps in FY11 to 12.3%, driven by pricing, leverage and continued productivity within the company's existing facilities. Technical Products margins are expected to expand by 125bps in FY11 to 16.5% due to price increases more than offsetting general raw material inflation, moderating operating expenses and volume leverage. We note that the company's margin expansion expectations for FY11 imply little or no benefit from higher prices. Indeed, should raw material cost inflation mitigate in FY11, given the company's strategy to secure greater-than-necessary price increases, there may be a potential upside to the company's margin guidance in 2H11. At this time, however, we do not expect any meaningful correction in the company's purchased raw materials. More detail is provided in our February 2, 2011 note, *PNR: Raising Price Target To \$41 After 4Q Beat*.

**WATER UTILITIES UPDATES**

Chile to Move Forward with Water Asset Sale – The Chilean government is making progress with its plans to sell a minority stake in four water utilities, including Aguas Andinas SA, the country's biggest water company. Chile holds 45.4% of utility Essal, 43.4% of Essbio, 34.9% of Aguas Andinas, and 29.3% of Esva. The assets have provided the agency with income of \$150M annually and the Chilean government hopes to raise \$1.6B from the sale. The government has stated that it may use 25% of the proceeds from the sale to fund the expansion of the capital's metro system, which it is a majority owner of. The government may also allocate another 25% to funding entrepreneurship programs, and at least 50% to additional infrastructure investments. The government originally intended to use the full proceeds of the asset sale to fund efforts to rebuild infrastructure that was damaged by the earthquake that devastated central-southern parts of the country in February 2010. Though the asset sale is intended to proceed, it has come under fire from a number of non-governmental organization (NGOs) who argue that the asset sale would eventually lead to an increase in tariffs that may not necessarily be compensated with improved services. Chile currently has some of the highest water rates in Latin America. Regional utility Esva, for example, charges \$2.25/m³, while Santiago's Aguas Andinas charges \$1.34/m³. A survey of 23 of Latin America's major cities found the average tariff to be \$0.03/m³, well below the average cost in Chile. Chile's government chose IM Trust, Bank of America Merrill Lynch and Banchile-Citi to advise it on the sale of stakes in water companies.

Source: Bloomberg

Northumbrian Water Seeks Loan Commitments – Northumbrian Water (NWG.LN, NR) has announced that it seeks to close £375M in loan commitments in 1H11 to cover its financing needs through March 2012. The company is negotiating a £150M loan from the European Investment Bank, as well as £100M of short-term facilities with a number of commercial banks for the company's water and sewerage businesses. Furthermore, the group seeks to replace £125M of debt at its interim holding company Northumbrian Services that matures in May. Last, the company noted that its capital spending plans for FY10-11 will come in below previous expectations due to cold weather in December that delayed a number of capital improvement programs. Expenditures in FY10-11 is now expected to total £200M.

Source: Global Water Intelligence

WATER INFRASTRUCTURE UPDATES

Mueller Water Reports Earnings – MWA (NR) reported 1Q11 EPS of (-\$0.08) vs. consensus expectations of (-\$0.05). Sales of \$288M were flat compared to the same period last year when excluding two divested businesses. Loss from operations for 1Q10 was \$4.3M, compared to income from operations of \$0.3M during the comparable period last year. Net sales for the Mueller Co. segment of \$130M declined 3% y/y. Lower shipment volumes reduced net sales \$7.9M, which were partially offset by \$3.7M of increased net sales due to higher prices. Sales declined due to higher inventory levels at the distribution level, in conjunction with what the company believes to be municipal market uncertainty. U.S. Pipe segment sales of \$74.4M declined 7% y/y. Higher prices of \$6.4M were more than offset by lower shipment volumes of \$11.7M. Anvil segment sales of \$83M declined 16% y/y due to the impact of two divested businesses. Otherwise, like-for-like sales increased 11% thanks to higher shipment volumes of \$5.5M and higher prices of \$2.7M. The company expects FY11 to be difficult due to rising raw material costs and municipal market uncertainty. Management noted that, "Spending growth on water infrastructure by municipalities appears to have slowed ... due to perceived uncertainty around both funding availability and financing costs." Nevertheless, the company expects marginal sales volume growth in 2H11, which coincides with the start of the construction season.

Source: Global Newswire

More Information Sought on Sale of AO Smith Unit – The federal government is seeking more information in its review of A.O. Smith's (AOS, NR) plan to sell its electrical products unit to Regal Beloit (RBC, N) for \$875M. Neither company elaborated as to what information was being requested by the federal government; however, both companies are complying with the request for additional information. Previously, AOS announced that it was selling its Electrical Products division to RBC for \$700M in cash and 2.83M shares of RBC stock. Subject to regulatory approval, the companies plan to close the sale during the first half of this year.

Source: The Associated Press

Northwest Pipe Announces Facility Expansion – NWPX (NR), a maker of engineered welded steel pipe and tube products, announced that it intends to expand its Atchison, Kansas mill facility, which is one of the company's three Tubular Products Group locations. The expansion, anticipated to be complete by 4Q11 will increase the production capacity at the facility by more than 50% and improve productivity

Source: Marketwire



Tetra Tech Reports Earnings – TTEK (NR) announced 1Q11 EPS of \$0.36, which exceeded consensus estimates of \$0.33. EPS included a \$0.02 tax benefit. Revenues of \$611M increased 12.8% from the prior year. Revenue, net of subcontractor costs, was \$406M, an increase of 18% from the prior year. Backlog was \$1.9B, up 18.5% from the prior year. The performance was driven by continued strength in the company's front-end consulting and engineering services divisions, along with its recent Canadian acquisitions that expanded its water services to the mining and energy markets. International business increased considerably and now accounts for 25% of revenues. Furthermore, commercial revenues expanded 11% y/y. Due to improved outlook in the company's international and commercial markets, TTEK increased its FY11 EPS guidance to \$1.32 to \$1.42.

Source: BusinessWire

END MARKET & INDUSTRY UPDATES

Alaska Bulk Water Company Receives Export Contract Extension – The Alaskan city of Sitka recently voted to extend – by six years – a bulk water export agreement with its sole water rights contractor, despite recent revelations that there may be a rift between the contractor and its partner in their venture to export Alaskan water to the middle east via large fleets of tankers. True Alaska Bottling, which holds the rights to 2.9B gallons of water per year, has reportedly severed its ties with S2C global, which was handling negotiations with potential buyers in India and other nations in the Middle East. Because of insufficient facilities abroad and construction work that still needs to take place in Sitka, True Alaska Bottling does not expect any exports to take place before 2012. True Alaska first received rights to Sitka water in 2006, and its failure to meet minimum export deadlines led to several contract renegotiations with the city. The most recent six year contract extension is the company's third and stipulates a \$150,000 penalty payable over two years if certain deadlines are not met.

Source: Circle of Blue

Great Lakes May Run Dry, Federal Report Says – Despite having more fresh water than anywhere else in the world, federal officials say that the Great Lakes region could possibly experience shortages in some locations because of climate shifts and surging demand. Though the Great Lakes have over six quadrillion gallons in supply, water levels have been steadily declining. In the Chicago-Milwaukee metro area, groundwater levels have plummeted about 1,000 feet because of pumping for municipal supplies and could drop an additional 100 feet over the next three decades if withdrawal rates jump as expected, according to the report. Furthermore, the 2.1B gallons that Chicago diverts from Lake Michigan

daily has lowered Lakes Michigan and Huron by about 2.5 inches. Although other metropolitan areas were not specifically cited in the report, anecdotal information suggests similar trends were occurring elsewhere. Just 1% of the lakes' water is replenished annually through runoff and precipitation, and vast amounts are removed for agriculture, industry, drinking and other uses. While demand has obviously impacted water levels, weather and climate appears to have had a bigger impact on water levels in recent years. Declining lake levels over much of the past decade resulted largely from drought and warming temperatures that limited winter ice cover and boosted evaporation.

Source: The Associated Press

Sydney Water Will Not be Privatized, Coalition Says – The Coalition has ruled out the privatization of Sydney Water in an attempt to appease unions. The Coalition noted that it does not want to privatize the water utility in that it seeks to ensure that water rate increases do not exceed the consumer price index. The Coalition has also stated that it will not sell the utilities' \$2B desalination plant, and instead has indicated that it instead hopes to offer a long term lease on the facility, while offering longer-term operations & maintenance contractors for the broader Sydney Water system.

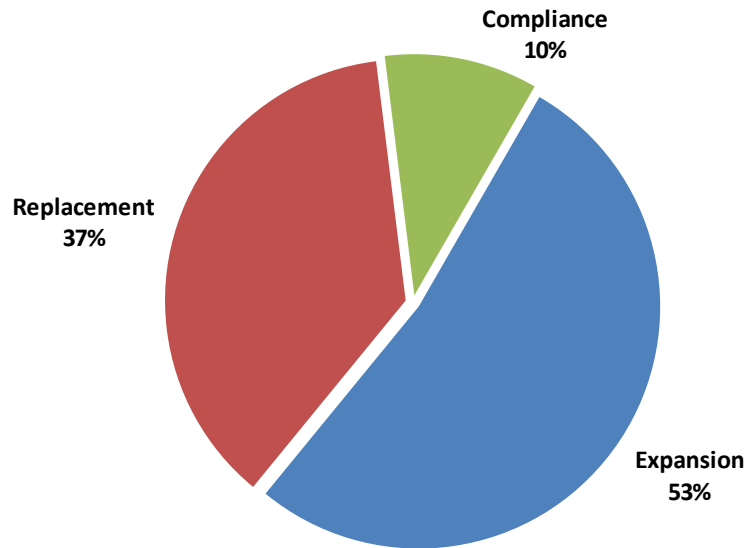
Source: The Sydney Morning Herald

Bahrain Wastewater Plant Contract Awarded – A consortium including Abu Dhabi's sovereign wealth fund (Invest AD) has been awarded a contract to build, own and operate (BOT) the eagerly anticipated Muharraq wastewater plant in Bahrain. The 27-year BOT contract for the plant includes Invest AD (35%), Samsung (45%) and United Utilities (20%). The facility was seen as the flagship of Bahrain's ongoing privatization program, though it has been stuck in the early bidding stages for over nine months. The plant will serve some 500,000 people in the Bahraini capital and will have an initial capacity of 100,000m³/d, with developers given the option of expanding this to 160,000m³/d. The project is expected to cost \$250M.

Source: Global Water Intelligence

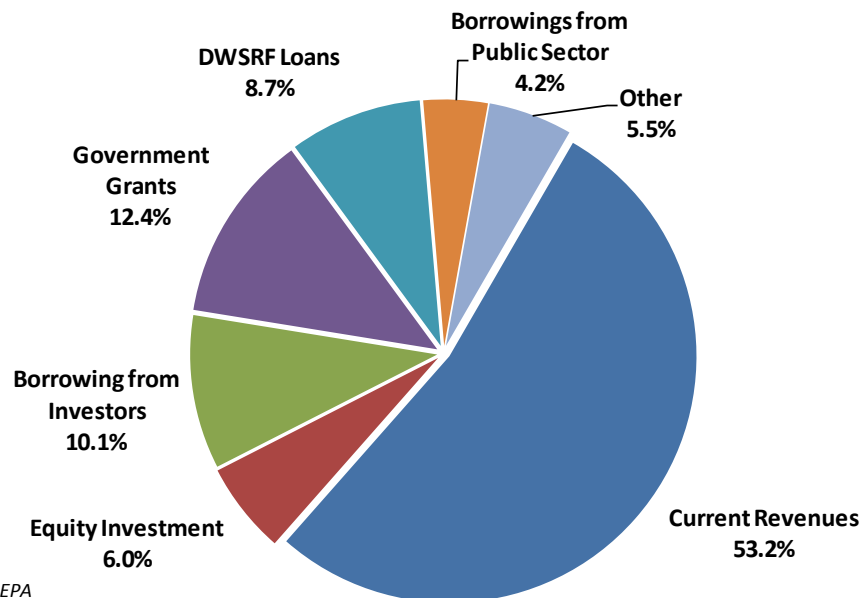


Water Industry Capital Expenditures



Source: EPA

Sources of Funding for Capital Projects



Source: EPA

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			\$33.60	\$39.61	\$31.20	\$ 626	\$ 361	1.62	1.78	2.15	18.9x	15.7x	3.1%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	8%	\$26.73	\$26.66	\$19.41	\$ 4,674	\$ 2,849	1.25	1.58	1.72	17.0x	15.6x	3.3%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$23.41	\$23.79	\$16.45	\$ 3,220	\$ 671	0.77	0.91	1.00	25.8x	23.5x	2.6%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$35.67	\$39.70	\$33.81	\$ 743	\$ 449	1.95	1.91	2.20	18.7x	16.2x	3.4%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$19.33	\$19.66	\$16.43	\$ 146	\$ 61	1.02	1.11	1.24	17.4x	15.6x	3.9%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$24.57	\$28.27	\$20.00	\$ 213	\$ 59	1.20	1.2	1.28	20.5x	19.2x	3.8%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$17.74	\$19.31	\$14.74	\$ 276	\$ 91	0.94	0.95	0.95	18.7x	18.7x	4.1%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$28.10	\$28.39	\$19.22	\$ 131	\$ 33	0.84	0.95	1.15	29.6x	24.4x	2.6%	1.8x
SIW	SIW	Dec.	NR			\$24.15	\$28.24	\$21.60	\$ 448	\$ 216	0.98	1.06	1.20	22.8x	20.1x	2.9%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$16.72	\$18.00	\$12.83	\$ 212	\$ 37	0.71	0.76	0.81	22.0x	20.6x	3.1%	2.1x
Average														21.1x	19.0x	3.3%	1.7x
EQUIPMENT/ FILTRATION/ TREATMENT SECTOR																	
PENTAIR	PNR	Dec.	BUY	\$39	2%	\$38.18	\$39.32	\$29.41	\$ 3,768	\$ 3,031	-16.87	-10.43	1.01	-3.7x	37.8x	2.1%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$37.36	\$37.79	\$27.51	\$ 1,384	\$ 1,234	1.54	1.92	2.23	19.5x	16.8x	1.2%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$70.16	\$85.25	\$55.42	\$ 649	\$ 503	5.10	3.22	4.25	21.8x	16.5x	1.7%	1.1x
BADGER METER	BMI	Dec.	NR			\$40.64	\$45.49	\$34.59	\$ 611	\$ 250	1.91	2.07	2.32	19.6x	17.5x	1.4%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$14.36	\$18.35	\$11.75	\$ 809	\$ 412	0.68	0.86	0.98	16.7x	14.7x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.66	\$6.77	\$3.08	\$ 192	\$ 47	-0.08	-	0.14	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$42.39	\$43.49	\$24.93	\$ 984	\$ 626	1.86	2.29	2.69	18.5x	15.8x	1.2%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$31.56	\$37.40	\$22.81	\$ 530	\$ 266	1.34	1.60	1.88	19.7x	16.8x	1.3%	2.6x
ITRON	ITRI	Dec.	NR			\$64.14	\$81.95	\$52.03	\$ 2,592	\$ 1,687	4.06	4.36	4.38	14.7x	14.6x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$31.95	\$36.92	\$22.97	\$ 625	\$ 866	1.42	1.63	1.63	19.6x	19.6x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$3.86	\$5.99	\$2.21	\$ 598	\$ 1,338	-0.19	0.12	0.15	NM	NM	1.8%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$23.19	\$25.50	\$14.62	\$ 215	\$ 283	0.12	0.73	1.47	31.8x	15.8x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$54.18	\$55.68	\$31.84	\$ 6,241	\$ 2,402	2.12	2.79	2.79	19.4x	19.4x	1.3%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$42.80	\$45.80	\$27.49	\$ 1,961	\$ 2,026	2.87	2.29	2.52	18.7x	17.0x	1.3%	1.9x
Average														20.3x	17.0x	0.8%	2.0x
WATER RESOURCES/ INFRASTRUCTURE																	
INSITUFORM TECH	INSU	Dec.	NR			\$28.54	\$29.17	\$18.52	\$ 1,119	\$ 727	1.52	1.80	2.31	15.9x	12.3x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$69.51	\$72.80	\$30.80	\$ 871	\$ 358	1.83	2.22	-	31.8x	25.5x	0.5%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$23.99	\$27.16	\$18.00	\$ 1,482	\$ 2,201	1.22	1.43	1.64	17.3x	15.2x	0.0%	1.7x
Average														20.6x	17.7x	0.6%	2.2x
Relevant Indices						Share Price											
Dow Jones Industrials						DJ30		\$12,092									
S&P 500						SPX		\$1,311									
Nasdaq Composite						NDX		\$2,338									

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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