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Industry: **WATER INFRASTRUCTURE**

Coverage:

Ticker	Rating	Price
AWK	BUY	\$25.23
AWR	NEUTRAL	\$35.32
CWT	NEUTRAL	\$38.38
PNR	BUY	\$36.39
WTR	NEUTRAL	\$22.21
WTS	NEUTRAL	\$36.50

The Water Rundown

Watts Water Survey Summary**End Market and Industry Updates**

- California's \$13B Water Tunnel Gets Federal, State Support
- Freshwater Sustainability Challenges Shared by Southwest and Southeast U.S.
- Saudi National Water Plans \$800M in New Projects in 2011
- Canada's Water Utilities May Be Put Up for Sale

Water Utilities Updates

- AWK and WTR Made a Trade, Optimize Respective Portfolios
- AWK Granted New Rates by Kentucky PSC
- AWK Closes Sale of \$30M of Unsecured Senior Monthly Notes

Industry Data and Graphs

- PPI, Water-Treating Compounds
- PPI, Alkalies and Chlorine

IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.



WATTS WATER SURVEY SUMMARY

We have completed our survey of commissioned manufacturer's representatives and the wholesale channel across the U.S. and Canada in order to measure demand, pricing, and sales trends of major WTS product lines.

Highlights from our **U.S. and Canada** survey results include:

- **On average, demand over the last month declined 4% y/y and 5% m/m.** Repair and remodel (>25% of demand) activity appears to be up in the low to mid single digits with new construction down y/y. Volumes were relatively stronger along the East Coast and Midwest and weakest in the West.
- **Price increases of 6-10%**, effective January 3rd, was recently announced by WTS in order to help offset rising raw material costs. 74% of our contacts expect the price increase to hold in full, with a further 21% expecting the price increase to hold at least in part. Contacts also noted that most competing manufacturers have announced increases of a similar magnitude.
- Despite many of our contacts expecting the price increase to hold, the majority **do not** expect the distribution channel to prebuy inventory ahead of the price increase.
- **Distribution inventories remain lean** following a brief period of inventory build in late 1H10. Lead times remain short with the distribution channel reportedly matching their inventory purchases to sell-through demand. Our contacts believe the channel's just-in-time inventory strategy will remain the norm throughout much of FY11.
- **The consensus outlook for 2011 is** was rather subdued as, on average, most contact expect flat to low single-digit demand growth for 2011. About half of contacts believe volumes will be up slightly with the other half anticipating flat volumes.

More information is available in our note titled *WTS: Price Increase to Lessen Impact of Rising Copper Costs* published earlier today.

END MARKET & INDUSTRY UPDATES

California's \$13B Water Tunnel Gets Federal, State Support

– California may potentially secure the funding for a \$13B “conveyance system” that would carry water from the northern part of the state to a region in the south that grows half of the nation's fresh produce. The project has been debated for nearly four decades, but Interior Secretary Kenneth Salazar recently released a status report that put the weight of the federal government behind the project. The state also released a similar report that outlined how the tunnel or canal would shuttle water from the northern end of San Francisco Bay and Sacramento-San Joaquin Delta to the south where it would be used for irrigation for farmers and drinking water for residents. A main concern for years was that the tunnel would interfere with local wildlife; however, the report issued by the state found that the tunnel would minimize interference with the wildlife on the ground while similarly provide a direct route for the transfer of water to Southern California customers. Completion of a tunnel is expected to take 10 to 15 years at a cost of \$13B.

Source: Bloomberg

Freshwater Sustainability Challenges Shared by Southwest and Southeast U.S.

– Water scarcity has been an ongoing problem for the Western U.S., but now a team of researchers has discovered that the Southeast, with the exception of Florida, does not have enough water capacity to meet its ongoing needs. In short, the researchers found that the Southeast has a relatively low capacity for water storage, which may inhibit future economic growth in the region. In order for water supply to be considered sustainable, the researchers calculated that no more than 40% of total freshwater resources could be appropriated for human use. The group also calculated how much water a region would need in order to meet all of its municipal, agricultural and industrial needs. The researchers found that neither the Southwest nor the Southeast have enough sustainable water capacity to meet their own needs and already import much of their water in the form of food. Most of the large population centers in the Southeast, such as Alabama, Charlotte and Birmingham have become increasingly dependent upon small watersheds, which may not be sufficient to support future growth, according to the researchers. Loss of storage capacity to sedimentation future exacerbates this trend.

Source: University of Georgia



Saudi National Water Plans \$800M in New Projects in 2011 – National Water Co., Saudi Arabia's state-owned utility, will begin construction on \$800M in new projects next year as the Arab world's biggest economy looks to improve its water-use efficiency. While the federal government intends to fund the entire cost of the project, the government wants the private sector to manage the water networks in order to conserve resources and ensure consistent supplies as population growth spurs demand. Various estimates suggest that the government needs to invest \$33B in desalination and water recycling plants to meet future demand as the country only gets about four inches of rain annually, most of which evaporates as temperatures can reach 122 degrees Fahrenheit in the summer. In order to meet the investment needs, the government is studying raising tariffs on consumption, as it did for electricity use earlier this year.

Source: Bloomberg

LBR Note: We continue to note the growth in desalination projects. Reflective of this, global desalination investment is expected to double from \$8.3 billion in 2010 to \$16.6 billion per year by 2016, representing cumulative spending of \$87.8 billion during that period, most of which would be spent on various "mega projects." By then, the top five markets in terms of installed capacity will be Saudi Arabia, the United Arab Emirates, the United States, China, and Israel. In sum, worldwide desalination capacity could reach 126M cubic meters per day by 2016, up from 76M presently. PNR (BUY, \$39PT) has positioned itself as the player in the desalination market and recently reiterated its commitment to increasing its exposure in the growing market through new product offerings and increased channel penetration, especially in the Middle East and China.

Canada's Water Utilities May Be Put Up for Sale – Canada's public water systems may be put up for sale as a result of a broad free trade agreement being negotiated by Canada and the European Union (EU), dubbed the Comprehensive Economic and Trade Agreement (CETA). Though the proposed agreement has generated little discussion among the Canadian population, a new report found that CETA may lead to the widespread privatization of Canada's water and wastewater infrastructure network, which is widely municipally owned and operated. In that at least \$31B is needed to cover the cost of the water/wastewater facility upgrades, and the estimated cost of the new sanitation regulations is \$20B, municipalities have quietly begun to support the initiative. The next round of CETA negotiations will take place between January 17 to 21, 2011 in Belgium.

Source: The Council of Canadians

WATER UTILITIES UPDATES

AWK and WTR Make a Trade, Optimize Respective Portfolios – AWK (BUY, \$29PT) and WTR (N) recently announced that AWK agreed to sell its regulated Texas operations to WTR and simultaneously purchase WTR's regulated Missouri operations. The acquisitions are subject to regulatory approval in each respective state and are expected to close by August 2011. AWK has agreed to purchase 11 regulated water and 59 regulated wastewater systems in Missouri for ~\$3M. The company currently serves 1.5M people throughout the state and the acquisition will increase AWK's customer count by 10,000 people (3,700 customer connections). WTR has agreed to purchase 51 water and five wastewater systems in Texas for ~\$6M. The systems serve a combined 16,000 people (5,300 customer connections) throughout the state, thereby increasing WTR's customer count in Texas by 8%. In general, we view the asset swap as a positive for both companies. For AWK, the company has a long-standing presence in MO and will thus be able to implement operational efficiencies to the acquired assets. Furthermore, MO offers a unique surcharge mechanism (ISRP) that allows AWK to submit two surcharge filings annually, which allows the company to accelerate the recovery of capex. Despite the purchase, the company expects to maintain its current capex forecast of \$800M to \$1B annually. We note that AWK still has a minimal non-regulated presence in Texas. In regard to WTR, the acquisition further points to its interest in expanding its presence in fast growth markets. Reflective of this strategy, nine of the company's 21 acquisitions in FY10 have been in Texas, where the company has realized 2% customer growth through 3Q10, two thirds of which has come from acquisitions. We believe the acquisition will allow WTR to realize maximum economies of scale in Texas, while further streamlining its rate case filing procedures.

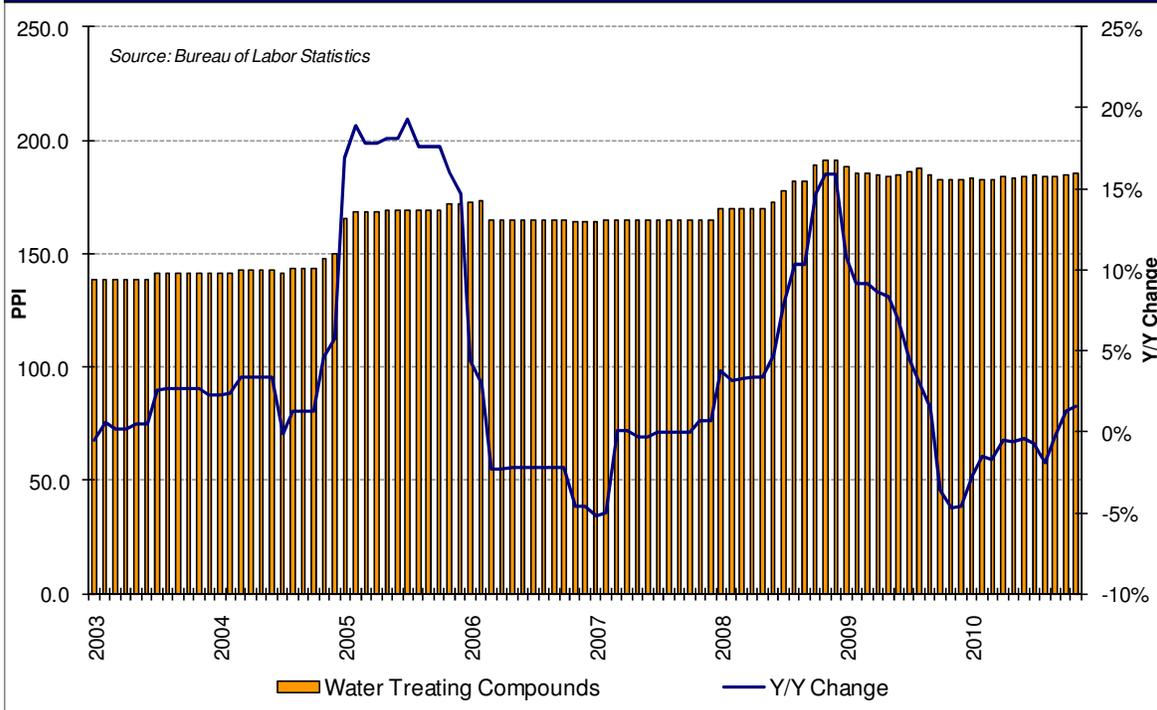
AWK Granted New Rates by Kentucky PSC – AWK announced that the Kentucky Public Service Commission (PSC) has approved new rates for the company's customers in Kentucky. The ruling is in response to a rate request filed by AWK in 1Q10 and will allow the company to increase its annual revenues by \$18.8M. The rate increase request was based on the \$164M the company invested in the construction of a new treatment plant, underground pipeline to deliver the water and other related facilities. The rates approved by the Kentucky PSC are lower than the temporary rates the company implemented on Sept. 29, as allowed by state laws. As a result, the company will refund the difference to its customers, plus interest, through a credit on the customer's bills.



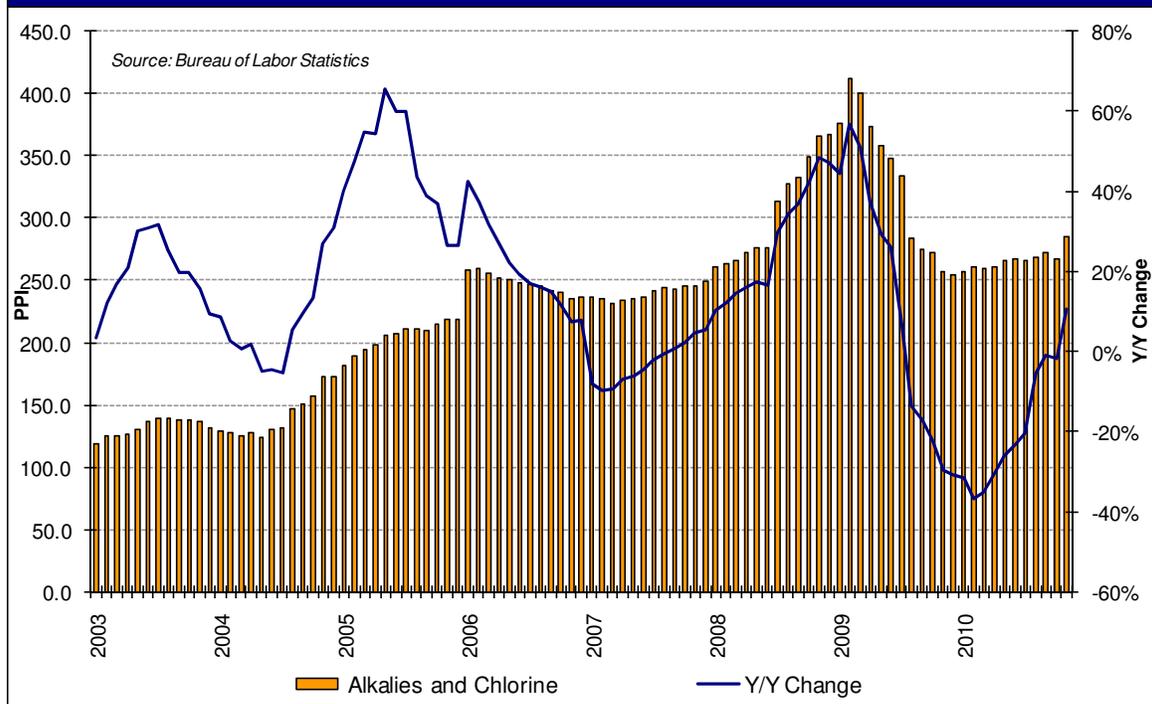
AWK Closes Sale of \$30M of Unsecured Senior Monthly Notes – AWK announced that its financing arm successfully closed a 30-year \$30M taxable debt offering. The unsecured senior notes have a 6% coupon rate and mature on December 1, 2040. The unsecured notes also have a five-year call option and can be redeemed at par on or anytime after December 1, 2015. The company intends to use the proceeds of the offering to fund the repayment of short term debt, most of which was used to fund capital infrastructure investments.



PPI, Water-Treating Compounds



PPI, Alkalies and Chlorine



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			\$35.32	\$39.61	\$31.20	\$ 657	\$ 361	1.62	1.78	2.15	19.9x	16.5x	2.9%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	15%	\$25.23	\$25.38	\$19.41	\$ 4,412	\$ 2,841	1.25	1.55	1.70	16.3x	14.8x	3.5%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$22.21	\$22.50	\$16.45	\$ 3,049	\$ 671	0.77	0.92	1.00	24.0x	22.3x	2.8%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$38.38	\$39.70	\$33.81	\$ 799	\$ 449	1.95	1.91	2.20	20.1x	17.5x	3.1%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$18.82	\$19.59	\$16.43	\$ 142	\$ 61	0.97	1.02	1.11	18.5x	17.0x	4.0%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$26.96	\$27.51	\$20.00	\$ 233	\$ 59	1.19	1.2	1.19	22.5x	22.7x	3.4%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$19.00	\$19.31	\$14.74	\$ 295	\$ 91	0.94	0.95	20.2x	20.0x	3.8%	1.7x	
PENNICHUCK	PNNW	Dec.	NR			\$27.40	\$28.39	\$19.00	\$ 128	\$ 33	0.55	0.84	0.95	32.6x	28.8x	2.7%	1.8x
SIW	SIW	Dec.	NR			\$26.62	\$28.24	\$21.50	\$ 494	\$ 216	0.81	0.98	1.06	27.2x	25.1x	2.6%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$17.70	\$18.00	\$12.83	\$ 224	\$ 37	0.64	0.71	0.76	24.9x	23.3x	3.0%	2.1x
Average														22.6x	20.8x	3.2%	1.7x
EQUIPMENT/ FILTRATION/ TREATMENT SECTOR																	
PENTAIR	PNR	Dec.	BUY	\$39	7%	\$36.39	\$39.32	\$29.41	\$ 3,592	\$ 2,692	1.47	1.96	2.28	18.5x	15.9x	2.1%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$36.50	\$37.00	\$27.51	\$ 1,346	\$ 1,234	1.54	1.92	2.23	19.1x	16.4x	1.2%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$84.11	\$84.24	\$55.42	\$ 778	\$ 547	3.05	2.90	3.84	29.0x	21.9x	1.4%	1.1x
BADGER METER	BMI	Dec.	NR			\$43.75	\$45.15	\$32.58	\$ 657	\$ 250	1.80	1.91	2.08	22.9x	21.0x	1.3%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$15.21	\$18.35	\$11.75	\$ 854	\$ 412	0.69	0.68	0.86	22.4x	17.7x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.64	\$7.28	\$3.08	\$ 191	\$ 47	0.07	(0.08)	-	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$40.82	\$41.37	\$24.93	\$ 948	\$ 626	1.29	1.86	2.26	21.9x	18.1x	1.3%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$36.46	\$37.40	\$22.81	\$ 612	\$ 266	1.15	1.34	1.6	27.2x	22.8x	1.2%	2.6x
ITRON	ITRI	Dec.	NR			\$54.44	\$81.95	\$52.03	\$ 2,198	\$ 1,687	2.09	4.02	4.33	13.5x	12.6x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$35.18	\$36.92	\$22.97	\$ 688	\$ 866	0.81	1.42	1.67	24.8x	21.1x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$3.97	\$5.99	\$2.21	\$ 615	\$ 1,338	-0.29	(0.17)	0.15	NM	NM	1.8%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$23.62	\$31.46	\$14.62	\$ 219	\$ 283	-0.26	0.12	0.73	196.8x	32.4x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$50.00	\$51.01	\$31.84	\$ 5,833	\$ 2,402	1.77	2.50	2.5	20.0x	20.0x	1.3%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$38.79	\$45.80	\$27.39	\$ 1,776	\$ 1,991	1.90	2.70	2.9	14.4x	13.4x	1.4%	1.7x
Average														45.5x	20.0x	0.8%	2.0x
WATER RESOURCES/ INFRASTRUCTURE																	
INSITUFORM TECH	INSU	Dec.	NR			\$28.12	\$28.38	\$18.52	\$ 1,103	\$ 727	1.04	1.52	1.77	18.5x	15.9x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$67.12	\$72.80	\$30.80	\$ 838	\$ 358	1.11	1.79	2.19	36.7x	29.8x	0.5%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$26.42	\$28.18	\$18.00	\$ 1,631	\$ 2,201	1.22	1.25	1.43	21.7x	19.2x	0.0%	1.7x
Average														26.1x	19.7x	0.7%	2.1x
Relevant Indices						Share Price											
Dow Jones Industrials		DJ30				\$11,492											
S&P 500		SPX				\$1,244											
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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