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Industry: **WATER INFRASTRUCTURE**

Coverage:

Ticker	Rating	Price
AWK	BUY	\$26.62
AWR	NEUTRAL	\$33.22
CWT	NEUTRAL	\$36.04
PNR	BUY	\$38.14
WTR	NEUTRAL	\$23.43
WTS	NEUTRAL	\$40.03

The Water Rundown

Water Utilities Updates

- Consumers Urge Rejection of California America's 40% Rate Hike
- PNNW and City of Nashua File Joint Petition
- Suez Environment Reports Earnings, Sets Goals

Water Infrastructure Updates

- WTS Negotiates €115-120M Acquisition
- TTEK Awarded \$69M Contract
- NWPX to Upgrade Texas Mill
- BMI Reports Earnings

End Market & Industry Updates

- Water Shortages May Force Mideast Cooperation
- Chicago's Next Major Urged to Privatize City's Water System

Industry Data & Graphs

- Total 20-Year Need by Asset Type
- Total Regulatory vs. Non-Regulatory 20-Year Need

IMPORTANT DISCLOSURES ARE LOCATED IN THE APPENDIX.



WATER UTILITIES UPDATES

Consumers Urge Rejection of California America's 40% Rate Hike – Customer's of California American Water (AWK, BUY, \$29PT) recently urged state regulators to deny a proposed 40.3% water rate increase for the Sacramento area starting next year, arguing that they have already been pressured by rising costs during the economic downturn. Indeed, while most of the customers appeared to understand the legitimate need to raise prices, many argued that the present economic climate would make the higher prices a burden on customers in the region. AWK is seeking \$58M in rate hikes in California, including a \$17.8M hike over a three-year period for 180,000 of its customers in Sacramento County. The company has said the increases are tied to infrastructure improvements needed in the Sacramento area along with an aggressive meter retrofit program. The independent Division of Ratepayer Advocates (DRA) for the state Public Utilities Commission (PUC) previously filed a protest to the rate hikes, citing Sacramento and two other areas of California, in particular, where customers would face "unacceptable rate shock" under the proposed increase. AWK increased water rates for its Sacramento area customers by 24.3% last year. Going forward, the company is seeking additional rate hikes of 22.8% for 2012, 6.7% for 2013 and 7.1% for 2014. The Division of Ratepayer Advocates recommends a 13.8% increase in 2012, in contrast to the company's requested 22.8% rise that year. The office also recommends a rate decline in 2013.

Source: The Sacramento Bee

LBR Note: Given the increased levels of activism by the Division of Ratepayer Advocates (DRA), there is a potential for approved rate cases by the state PUC to come in below our expectations; however, for the time being, we remain comfortable with our view that 60% of the company's pending rate cases in California will be approved by the state PUC. We expect the PUC to issue a ruling on the rate increases by in mid-2011.

Pennichuk Water and City of Nashua File Joint Petition – PNNW (NR) announced that it has filed a joint petition with the City of Nashua, New Hampshire with the New Hampshire Public Utilities Commission (NHPUC) requesting that the NHPUC approve the acquisition of the company by the City. The company previously announced that it had entered into a merger agreement with the city pursuant to which Nashua is required to purchase all of the company's outstanding stock for \$29/share, or ~\$138M in cash. The company expects that the public hearings by the NHPUC may extend well into 2H11.

Suez Environment Reports Earnings, Sets Goals – SEV.FR (NR) recently reported FY10 revenues of €13.9B, an increase of 13% y/y, and announced that it had met all of its annual targets, which were raised mid-year on account of better than expected business conditions. Organic sales increased 8.6%, led by accelerated growth in the International segment (+17.7% y/y), Waste Treatment segment (+8.4%) and European Water segment (+0.8%). Aside from reporting strong earnings on a broad improvement across the company's diverse operating base, the company set a number of growth goals for the next three years. The company is targeting EBITDA growth of at least 10% in FY11 and at least 7% in FY12 and FY13. The company also pledged to pay out 60% of its profits in dividends going forward, and furthermore expects dividends to increase by around 5% annually over the next three years, in line with management's revenue growth forecasts. Furthermore, the company remains focused on expanding internationally, though Europe still accounts for ~70% of sales vs. 80% in FY08.

WATER INFRASTRUCTURE UPDATES

Watts Water Negotiates €115-120M Acquisition – WTS (N) has announced that it is in negotiations to purchase the water controls business of Danfoss A/S (private) for €115-120M. Danfoss Socla, based in France, manufactures valves and other flow control solutions, and posted revenues of €72M in 2009. Danfoss reportedly intends to retain its pump manufacturing and RO Solutions division.

Source: Longbow Research

LBR Note: We expect management to offer further color on the potential acquisition during its February 25th earnings conference call. We are encouraged that WTS has decided to put its \$292M cash on hand to use after a recent dry-spell for acquisitions.

Tetra Tech Awarded \$69M Contract – TTEK (NR) has announced that it has been awarded a \$69M contract to help the U.S. Agency for International Development (USAID) to strengthen and support land management and report in Afghanistan. Under the three-year program, TTEK will provide technical assistance to help strengthen land tenure security, improve management of revenue from state lands, and advise on appropriate models for land dispute resolution.



Northwest Pipe to Upgrade Texas Mill – NWPX (NR), a manufacturer of engineered welded steel pipe, announced that it will expand its Houston, Texas mill in response to customer demands for greater product offerings. The mill previously produced only mechanical tubing products, but began to produce green tube for OCTG in 2010. The mill upgrade will build on the OCTG green tube process.

Badger Meters Reports Earnings – BMI (NR) reported 4Q10 EPS of \$0.42 vs. consensus of \$0.42 and FY10 EPS of \$1.91, both record amounts for the company. Revenues of \$68M during the quarter increased 15% from the year ago period due to strong demand for the company's automatic meter reading (AMR) and advanced metering infrastructure (AMI) technology products. In addition, management noted that increased sales in 4Q10 were on account of the recent addition of Flow Measurement products and services, higher sales of products for residential water applications and the continued improvement in sales of specialty products. Management noted that higher raw material costs, notably copper, were partially offset by price increases and ongoing cost controls, resulting in a gross profit margin of 37.2% for FY10 vs. 38.8% in FY09, a 160bps decline. 4Q10 gross margins of 38% increased 160bps from the year ago period. The increase was credited to increased sales of the company's specialty products, which typically have higher margins.

END MARKET & INDUSTRY UPDATES

Water Shortages May Force Mideast Cooperation – A report for the Swiss and Swedish governments warned on Thursday that water shortages in the Middle East were so alarming that opposition parties and nations in the region would have little choice but to cooperate as conditions worsen. The Swiss government called on leaders in Turkey, Iraq, Syria, Lebanon, Jordan, the Palestinians and Israel to increase cooperation on managing scarce water resources in the region, arguing that water could also be used to forge a "blue peace." The report noted that five of the seven countries are experiencing a structural shortage and the debit of most of the big rivers has declined by 50 to 90 percent between 1960. Indeed, while oil has been used as a geopolitical resource in years past, the researchers argue that water may soon replace it as a highly contested resource in the years to come, and are therefore arguing the need for cooperation amongst those governments in the near term. The report went on to highlight the huge depletion of major rivers such as the Jordan and Yarmouk in the past half a century, as well as the punctual depletion of the Euphrates by drought and the shrinkage of the Dead Sea to a small lake by 2050. Turkey, being upstream, is in a position to "influence prospects of peace" despite the recent collapse of plans to pipe water to Israel and other Gulf states. However, downstream countries such as Israel, Jordan and Palestinian territories were in the worst position with

mounting clean water deficits of up to 500-700M cubic meters each. The researchers argued that desalination may only have a limited impact in the near term, and that the nations in the region will need to look for external sources and regional cooperation beyond 2020 to ensure its water security.

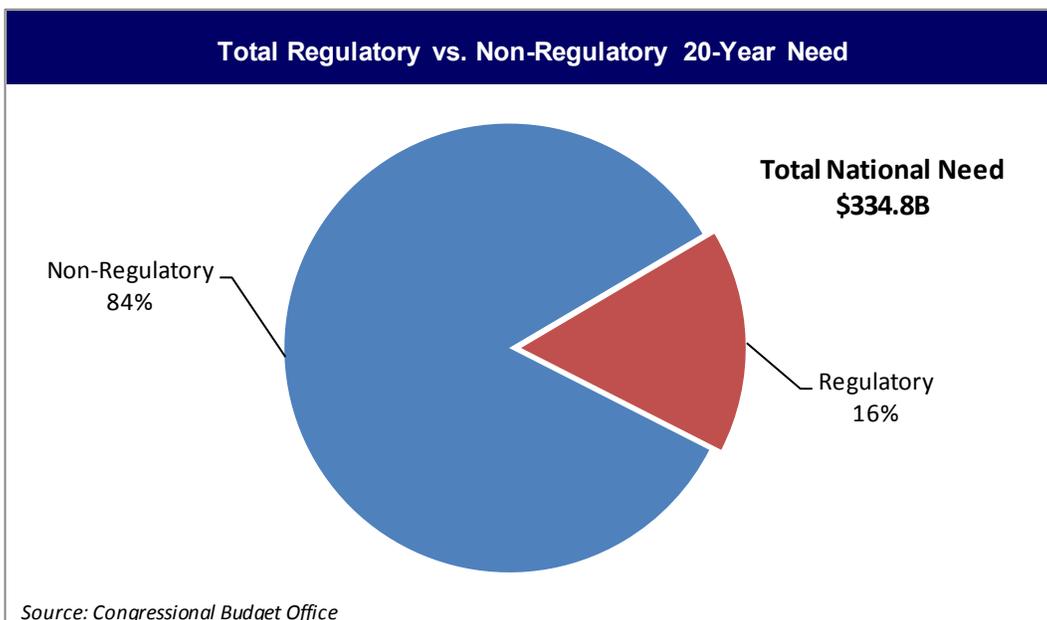
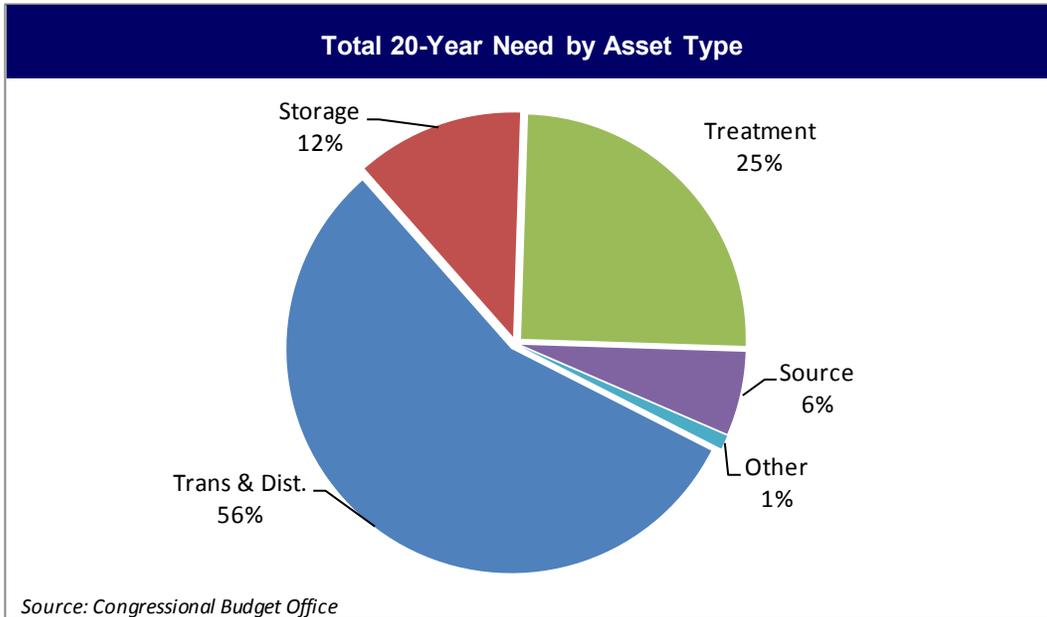
Source: AFP

Chicago's Next Mayor Urged to Privatize City's Water System

– In a detailed report on Chicago's finances, the Civic Federation, non-partisan government research organization, has urged the next mayor to privatize the city's water system, as well as a number of other city assets, to help resolve a structural deficit that has the city on the brink of bankruptcy. Indeed, in the nine years ending in 2009, the city's debt rose by a staggering 122% to \$6.9B, while just \$96.9M (15%) of the city's 2011 budget gap has been closed with spending cuts. The Civic Federation argues that the remaining balance should be filled with proceeds from asset sales. While Chicago's current mayor will have little say on the matter, the Civic Federation hopes their report will be used as a blueprint by the city's next mayor.

Source: Chicago Sun Times.

LBR Note: A number of industry participants have argued that budget pressures on the local level would result in a steady flow of asset sales by municipalities seeking to raise the necessary capital in the near term, while escaping the obligation of future infrastructure upgrades as systems deteriorate due to a lack of necessary upkeep. While the sale of Chicago's water assets does not appear to be likely in the near term, we note that the city has privatized a number of its assets in recent years, including its parking meters in a 75-year \$1.15B lease with a consortium of investors.



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			\$33.22	\$39.61	\$31.24	\$ 619	\$ 361	1.62	1.78	2.15	18.7x	15.5x	3.1%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	9%	\$26.62	\$26.88	\$19.41	\$ 4,655	\$ 2,849	1.25	1.58	1.72	16.9x	15.5x	3.3%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$23.43	\$23.79	\$16.52	\$ 3,223	\$ 671	0.77	0.91	1.00	25.8x	23.5x	2.6%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$36.04	\$39.70	\$33.81	\$ 751	\$ 449	1.95	1.91	2.20	18.9x	16.4x	3.4%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$19.31	\$19.66	\$16.43	\$ 146	\$ 61	1.04	1.15	1.24	16.8x	15.6x	3.9%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$24.80	\$28.27	\$20.00	\$ 215	\$ 59	1.20	1.2	1.28	20.7x	19.4x	3.8%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$18.64	\$19.31	\$14.74	\$ 290	\$ 91	0.94	0.95	0.95	19.6x	19.6x	3.9%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$28.18	\$28.39	\$19.64	\$ 131	\$ 33	0.84	0.95	1.15	29.7x	24.5x	2.6%	1.8x
SIW	SIW	Dec.	NR			\$24.34	\$28.24	\$21.70	\$ 451	\$ 216	0.98	1.06	1.20	23.0x	20.3x	2.8%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$17.20	\$18.00	\$12.83	\$ 218	\$ 37	0.71	0.76	0.81	22.6x	21.2x	3.0%	2.1x
Average														21.3x	19.1x	3.2%	1.7x
EQUIPMENT/ FILTRATION/ TREATMENT SECTOR																	
PENTAIR	PNR	Dec.	BUY	\$41	7%	\$38.14	\$39.32	\$29.41	\$ 3,764	\$ 3,031	-16.87	-10.43	1.01	-3.7x	37.7x	2.1%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$40.03	\$39.52	\$27.51	\$ 1,482	\$ 1,234	1.54	1.92	2.23	20.9x	18.0x	1.1%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$70.29	\$85.25	\$55.42	\$ 650	\$ 503	5.10	3.22	4.25	21.8x	16.5x	1.7%	1.1x
BADGER METER	BMI	Dec.	NR			\$41.26	\$45.49	\$35.21	\$ 620	\$ 277	1.88	2.05	2.31	20.1x	17.9x	1.4%	3.9x
CALGON CARBON	CCC	Dec.	NR			\$14.08	\$18.35	\$11.75	\$ 793	\$ 412	0.68	0.86	0.98	16.4x	14.4x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.42	\$6.77	\$3.08	\$ 179	\$ 47	-0.08	-	0.14	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$44.59	\$43.71	\$26.71	\$ 1,035	\$ 626	1.86	2.29	2.69	19.5x	16.6x	1.2%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$38.16	\$37.40	\$22.81	\$ 641	\$ 297	1.53	1.75	2	21.8x	19.1x	1.1%	2.6x
ITRON	ITRI	Dec.	NR			\$63.39	\$81.95	\$52.03	\$ 2,561	\$ 1,687	4.06	4.38	4.35	14.5x	14.6x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$32.35	\$36.92	\$22.97	\$ 633	\$ 866	1.42	1.63	1.63	19.8x	19.8x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$3.98	\$5.99	\$2.21	\$ 618	\$ 1,338	-0.19	0.01	0.15	NM	NM	1.8%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$23.93	\$25.50	\$14.62	\$ 222	\$ 283	0.12	0.73	1.47	32.8x	16.3x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$55.13	\$55.68	\$31.84	\$ 6,350	\$ 2,402	2.12	2.79	2.79	19.8x	19.8x	1.3%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$42.50	\$45.80	\$29.03	\$ 1,947	\$ 2,026	2.87	2.07	2.47	20.5x	17.2x	1.3%	1.9x
Average														21.2x	17.6x	0.7%	2.0x
WATER RESOURCES/ INFRASTRUCTURE																	
INSITUFORM TECH	INSU	Dec.	NR			\$29.97	\$29.96	\$18.52	\$ 1,176	\$ 727	1.52	1.80	2.31	16.6x	13.0x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$70.70	\$72.80	\$30.80	\$ 886	\$ 358	1.83	2.22	-	32.4x	26.0x	0.5%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$23.92	\$27.16	\$18.00	\$ 1,477	\$ 2,201	1.22	1.41	1.64	17.1x	15.1x	0.0%	1.7x
Average														21.3x	18.1x	0.6%	2.2x
Relevant Indices						Share Price											
Dow Jones Industrials		DJ30				\$12,273											
S&P 500		SPX				\$1,329											
Nasdaq Composite		NDX				\$2,379											

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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