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Industry: **WATER INFRASTRUCTURE**

Coverage:

<b>Ticker</b>	<b>Rating</b>	<b>Price</b>
AWK	BUY	\$25.98
AWR	NEUTRAL	\$35.24
CWT	NEUTRAL	\$37.68
PNR	BUY	\$36.98
WTR	NEUTRAL	\$23.33
WTS	NEUTRAL	\$36.91

## The Water Rundown

### Water Infrastructure Updates

- ITT to Split Into Three New Companies
- TTEK Announces Acquisition
- TTEK Awarded \$62M Contract
- Consortium Wins Water Concession

### End Market and Industry Updates

- Utilities Operating at a Loss, Survey Says
- EPA Order Facilities Across Southeast to Comply with CWA
- Water Prices Decline in Paris
- SAWS Calls for Private Water Projects
- Nevada's Water Supply In Jeopardy

### Industry Data and Graphs

- Water Industry Capital Expenditures
- Sources of Funding for Capital Projects

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



## WATER INFRASTRUCTURE UPDATES

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**ITT to Split Into Three New Companies** – ITT (NR) announced that it plans to split into three publicly traded companies focused on water management, aerospace & defense, and industrial products. The move is in an attempt to decouple the company's commercial businesses from its defense segment, which is expected to underperform in the coming years due to lower U.S. spending on military programs. Though the segments stability during the economic downturn offset declines witnessed in its other segments, its presence is now viewed as an inhibitor of growth and value. The company expects to do a tax-free spinoff into three new companies, with ITT shareholders receiving shares of each of the three new companies. The water business, which has been expanding through a series of recent acquisitions, will remain focused on the testing and treatment of water and wastewater for municipalities and industrial companies. We note the water business is a direct competitor to PNR and boasts a similar size and scale.

**Tetra Tech Announces Acquisition** – TTEK (NR), an environmental engineering firm, announced that it will acquire Fransen Engineering, a Canadian engineering and consultancy firm, in an attempt to enter the oil sands market. Frances has some 180 employees and generated about \$27M in TTM revenues. The company is also exposed to the Canadian market, as 25% of Fransen's customers are based in Canada. TTEK did not disclose the terms of the transaction, but does expect the transaction to close in 2Q11 (ending in April). The company did not say what sort of impact the acquisition would have on earnings.

**Tetra Tech Awarded \$62M Contract** – TTEK (NR), an environmental engineering firm, announced that it has been awarded a five-year, \$62M contract to support the U.S. Environmental Protection Agency (EPA) in protecting U.S. waterways. The contract is 45% larger than the predecessor contract TTEK held with the EPA, to which the company has been providing services since the 1970s.

**Consortium Wins Water Concession** – A consortium of SPML Infra (80% share), VA Tech Wabag (10%) and Uganda's National Water and Sewage Corporation (10%), has been declared the lowest bidder in a \$221M water concession by the Aurangabad Municipal Corporation in India. The 20-year concession includes the construction of a water treatment plant, laying pipeline networks, non-revenue water reduction, metering, billing and O&M. The government will reportedly contribute \$88M to the projects, whereas the consortium members will furnish the remainder.

## END MARKET AND INDUSTRY UPDATES

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**Utilities Operating at a Loss, Survey Says** – The percentage of community water systems (CWS) operating at a loss increased between 2000 and 2006, according to a recent survey conducted by the Environmental Protection Agency (EPA). The survey revealed that a rise in expenses outpaced an increase in revenues for most and especially for publically owned (not publically traded) systems. We note that community water systems are public water systems that supply water to a stable customer base. They comprise approximately 33% of all public water systems in the US. Indeed, publically owned water systems averaged a 57% increase in expenses between 2000 and 2006, compared to a meager 15% increase in revenues. While the gap was recognized in almost all of the systems surveyed, it was most apparent for those systems serving more than 100,000 customers. For those systems, expenses increased an average of 61% and were offset by just a 1% increase in revenues. Privately owned systems appeared to be better off. For such systems, a 29% increase in expenses was more than offset by a 64% increase in revenues, on the average. That being said, privately owned systems serving less than 500 customers experienced a 64% increase in expenses and a 1% decline in revenues.

The survey also revealed that the number of CWSs declined by 6% between 2000 and 2006. The decline was largely due to industry consolidation and acquisitions. As of 2006, there were 4,847 publically owned and 24,287 privately owned systems of all sizes. The 49%-private CWS category comprises 22% as for-profit businesses and 38% as not-for-profit. Again, this survey does not include publically-traded water utilities.

In regard to capital expenditures, the percentage of publically owned systems making major capital investments has increased, while the number of privately owned systems doing so decreased, when compared to the EPA's 2000 survey. In total, 53% of capex was spent on expansion, compared to 37% for replacement and 10% for EPA compliance.

In regard to financing capital spending projects, 32% of the cost is covered through revenues, though publically owned systems have increasingly become reliant upon loans from the Drinking Water State Revolving Funds to finance projects, which now accounts for 19% of a project's cost vs. just 10% in 2000.

*Source: AWWA*



*LBR Note: The most notable takeaway from the EPA's survey is that municipally/private water utilities are exceedingly reliant upon general revenues, which have increased only moderately from the 2000-2006 time period, to fund capital expenditure programs. As systems age beyond their intended life and are forced to make costly infrastructure upgrades, especially those mandated by the EPA, we would expect that a portion of municipally/private water utilities opt instead to sell their assets to publically-traded water utilities. In general, most publically-traded utilities prefer to acquire those systems in need of considerable capex due to their ability to secure the needed funds through internally generated cash and then recover their investment through rate increases, which are subject to state utility commission approvals.*

**EPA Orders Facilities Across Southeast to Comply with Clean Water Act** – The U.S. Environmental Protection Agency (EPA) announced that it has issued Administrative Orders (AOs) against seven entities in North Carolina, Tennessee, Kentucky and South Carolina during the last quarter of 2010 for violations of the Clean Water Act (CWA). Three of the entities were cited for alleged stormwater violations of the CWA, which is a leading cause of impairment to the 40% of surveyed U.S. water bodies which do not meet federal water quality standards. Stormwater violations usually refer to stormwater overflows, which is when periods of heavy rains cause polluted runoff to be discharged, usually untreated, into local waterways. The remaining entities were charged for other various offenses, including sanitary sewer overflows (SSO) and unauthorized discharges of wastewater. Each entity will be required to make various infrastructure upgrades to be in compliance with the Clean Water Act.

*Source: U.S. EPA*

*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.*

**Water Prices Decline in Paris** – Water prices in Paris are set to decline in the spring, less than a year after the city took over control of its water distribution system following the December 2009 expiration of a contract with Veolia Water (VE, NR) and Suez Environment. It is unclear how precipitous the decline will be, but most government officials have pointed to a 5-10% decline in average prices. Water prices in the city are already well below the national average. Government officials are reducing rates as the system has been able to generate net income of €40M annually on revenues of €230M.

*Source: Water Watch*

**SAWS Calls for Private Water Projects** – The San Antonio Water System has issued a request for competitive proposals from providers or companies that could supply San Antonio with 20,000 acre-feet of water annually by 2020. In general, one acre-foot is able to supply three or four homes with water for a year. The bidding requirements include that the water cannot be based on permits to pump from the Edwards Aquifer that could be sold or leased to SAWS and pumped with the utility's existing infrastructure. The SAWS issued a similar request last year and received a bid from the Guadalupe Blanco River Authority, which offered to build a pipeline from Austin, as well as a bid from T. Boone Pickens, who offered to build a pipeline from the Texas Panhandle. The SAWS is now asking for a more detailed response, including costs, and has set a deadline of July 22.

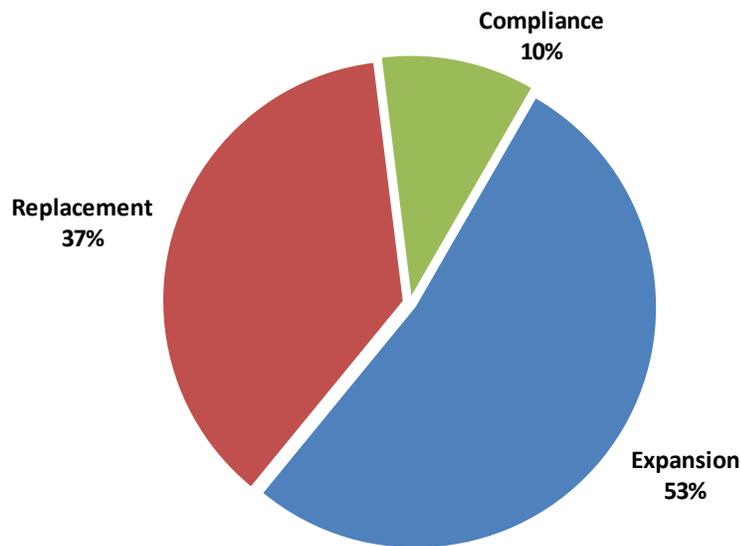
*Source: Express News*

**Nevada's Water Supply in Jeopardy** – Drinking water availability in Southern Nevada is at a critical junction according to the Southern Nevada Water Authority. The general manager of the Authority announced that it will be out of water in just nine years. As a result, he pleaded that residents and businesses in Southern Nevada reduce consumption, though this may only extend the timeframe marginally. The Southern Nevada Water Authority gets its water from Lake Mead, which is currently at just 53% capacity. In 2000, the lake was at 96% capacity.

*Source: WorldNow*

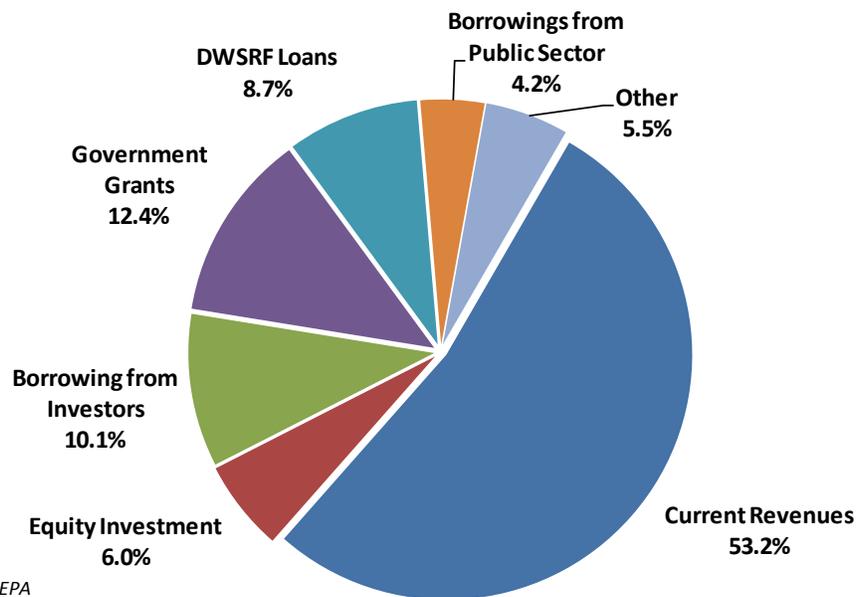


### Water Industry Capital Expenditures



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		
<b>U.S. WATER UTILITIES</b>																	
AMER STATES WATER	AWR	Dec.	Neutral			\$34.34	\$39.61	\$31.20	\$ 639	\$ 361	1.62	1.78	2.15	19.3x	16.0x	3.0%	1.8x
AMERICAN WATER WORKS	AWK	Dec.	BUY	\$29	13%	\$25.67	\$25.82	\$19.41	\$ 4,489	\$ 2,841	1.25	1.55	1.70	16.5x	15.1x	3.4%	1.0x
AQUA AMERICA	WTR	Dec.	Neutral			\$22.79	\$22.97	\$16.45	\$ 3,135	\$ 671	0.77	0.92	1.00	24.7x	22.8x	2.7%	2.2x
CALIFORNIA WATER	CWT	Dec.	Neutral			\$37.36	\$39.70	\$33.81	\$ 778	\$ 449	1.95	1.91	2.20	19.5x	17.0x	3.2%	1.8x
ARTESIAN RESOURCES	ARTNA	Dec.	NR			\$19.06	\$19.63	\$16.43	\$ 144	\$ 61	0.97	1.02	1.11	18.7x	17.2x	4.0%	1.5x
CONNECTICUT WATER	CTWS	Dec.	NR			\$26.05	\$28.27	\$20.00	\$ 225	\$ 59	1.19	1.2	1.19	21.7x	21.9x	3.6%	2.0x
MIDDLESEX WATER	MSEX	Dec.	NR			\$18.65	\$19.31	\$14.74	\$ 290	\$ 91	0.72	0.94	0.95	19.8x	19.6x	3.9%	1.7x
PENNICHUCK	PNNW	Dec.	NR			\$27.35	\$28.39	\$19.00	\$ 128	\$ 33	0.55	0.84	0.95	32.6x	28.8x	2.7%	1.8x
SIW	SIW	Dec.	NR			\$25.39	\$28.24	\$21.60	\$ 471	\$ 216	0.81	0.98	1.06	25.9x	24.0x	2.7%	1.7x
YORK WATER CO (THE)	YORW	Dec.	NR			\$16.38	\$18.00	\$12.83	\$ 208	\$ 37	0.64	0.71	0.76	23.1x	21.6x	3.2%	2.1x
Average														22.2x	20.4x	3.2%	1.7x
<b>EQUIPMENT/ FILTRATION/ TREATMENT SECTOR</b>																	
PENTAIR	PNR	Dec.	BUY	\$39	7%	\$36.52	\$39.32	\$29.41	\$ 3,604	\$ 2,692	1.47	1.96	2.28	18.6x	16.0x	2.1%	1.6x
WATTS WATER TECH	WTS	Dec.	Neutral			\$36.71	\$37.79	\$27.51	\$ 1,359	\$ 1,234	1.54	1.92	2.23	19.2x	16.5x	1.2%	1.3x
AMERON INT'L	AMN	Nov.	NR			\$76.48	\$85.25	\$55.42	\$ 707	\$ 547	3.05	2.90	3.84	26.4x	19.9x	1.6%	1.1x
BADGER METER	BMI	Dec.	NR			\$40.74	\$45.49	\$32.58	\$ 613	\$ 250	1.80	1.91	2.08	21.3x	19.6x	1.4%	4.1x
CALGON CARBON	CCC	Dec.	NR			\$14.14	\$18.35	\$11.75	\$ 796	\$ 412	0.69	0.68	0.86	20.8x	16.4x	0.0%	2.5x
ENERGY RECOVERY	ERII	Dec.	NR			\$3.91	\$7.20	\$3.08	\$ 205	\$ 47	0.07	(0.08)	-	NM	NM	0.0%	2.9x
FRANKLIN ELECTRIC	FELE	Jan.	NR			\$40.59	\$41.79	\$24.93	\$ 942	\$ 626	1.29	1.86	2.29	21.8x	17.7x	1.3%	1.7x
GORMAN-RUPP	GRC	Dec.	NR			\$32.07	\$37.40	\$22.81	\$ 538	\$ 266	1.15	1.34	1.6	23.9x	20.0x	1.3%	2.6x
ITRON	ITRI	Dec.	NR			\$56.87	\$81.95	\$52.03	\$ 2,298	\$ 1,687	2.09	4.02	4.33	14.1x	13.1x	0.0%	1.9x
LAYNE CHRISTENSEN	LAYN	Jan.	NR			\$32.94	\$36.92	\$22.97	\$ 645	\$ 866	0.81	1.42	1.63	23.2x	20.2x	0.0%	1.1x
MUELLER WATER PRODUC	MWA	Sept.	NR			\$4.50	\$5.99	\$2.21	\$ 697	\$ 1,338	-0.29	(0.17)	0.15	NM	NM	1.6%	1.2x
NORTHWEST PIPE	NWPX	Dec.	NR			\$22.54	\$29.19	\$14.62	\$ 209	\$ 283	-0.26	0.12	0.73	187.8x	30.9x	0.0%	1.0x
PALL	PLL	Jul.	NR			\$50.00	\$51.01	\$31.84	\$ 5,759	\$ 2,402	1.77	2.50	2.5	20.0x	20.0x	1.3%	3.7x
SMITH (A.O.)	AOS	Dec.	NR			\$39.47	\$45.80	\$27.39	\$ 1,808	\$ 1,991	1.90	2.70	2.91	14.6x	13.6x	1.4%	1.7x
Average														43.7x	19.4x	0.8%	2.0x
<b>WATER RESOURCES/ INFRASTRUCTURE</b>																	
INSITUFORM TECH	INSU	Dec.	NR			\$26.72	\$28.59	\$18.52	\$ 1,048	\$ 727	1.04	1.52	1.79	17.6x	14.9x	0.0%	1.6x
LINDSAY	LNN	Aug.	NR			\$62.20	\$72.80	\$30.80	\$ 779	\$ 358	1.11	1.68	2.21	34.0x	28.6x	0.5%	2.0x
TETRA TECH	TTEK	Sept.	NR			\$23.76	\$27.59	\$18.00	\$ 1,467	\$ 2,201	1.22	1.25	1.43	19.5x	17.2x	0.0%	1.7x
Average														24.9x	18.9x	0.7%	2.1x
<b>Relevant Indices</b>						<b>Share Price</b>											
Dow Jones Industrials		DJ30				\$11,675											
S&P 500		SPX				\$1,272											
Nasdaq Composite		NDX				\$2,277											

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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