

Water Stocks Defy General Market Trend



Since our inaugural installment in the May/June issue, in which we relied upon mid-April financial data, the Dow Jones Industrial Average is off by almost 10 percent, and the Standard and Poor's 500 Index is down even a bit more. However, as is often the case, during this downswing in the general markets, the performance of many water stocks rose slightly, and our overall *UIM* Performance Index crept up from 10.05 to 10.43.

This raises an interesting question for discussion this issue — why do we often seem to see this sort of lack of correlation, or even negative correlation, between broad market indices and water stocks?

First, a little background and recent history. As is well documented by now, strong investor interest and high growth expectations for the overall water industry have tended to push the price of many water stocks to a relatively high level. When the market slowed and then collapsed in the fall of 2008, many water stocks remained relatively strong; some analysts spoke of the “de-coupling” of water stocks from the overall market. And in turn, just as water stocks did not experience quite the

dramatic collapse that most equities exhibited during late 2008 and early 2009, neither did they participate as fully, from a percentage perspective, in the partial market recovery that began to take hold in mid-2009.

In stock market parlance, water stocks tend to have a low “beta” value — they just don't tend to move in lock-step with broader market trends. And analogous to the old “tortoise and the hare” analogy — many water companies (particularly the publicly traded water utility companies) continue to plug away more in the manner of a tortoise — less volatile and exciting than some other sectors, but typically more predictable and dependable, and probably more valuable to own in the long-term.

The usual rationale or explanation for this observed behavior is that water is a unique commodity — and that the demand for water is ultimately less elastic than is the case for almost any other commodity. Said another way — we all need a certain amount of water to live regardless of

WATER DOLLARS

Company	Price	% of 52-wk hi	Revenue	EBITDA	Market Cap.	Enterprise Val/ EBITDA	EBITDA/ Revenue	ROE	Performance <i>UIM</i> Index
Ameron (AMN)	62.37	68%	514	64	\$580	7.3	12.5%	6.1%	9.6
Badger Meter (BMI)	39.63	89%	247	48	\$594	12.2	19.4%	19.0%	17.2
Calgon Carbon (CCC)	13.64	74%	424	79	\$764	9.4	18.6%	14.9%	15.1
Cascal NV (HOO)	6.71	86%	182	63	\$205	6.3	34.6%	17.6%	22.7
Dionex (DNEX)	73.86	85%	407	86	\$1,300	14.2	21.1%	24.3%	19.7
Energy Recovery (ERII)	4	54%	47	6.2	\$210	25.8	13.2%	1.9%	14.7
Federal Signal (FSS)	6.17	60%	734	48	\$370	13.8	6.5%	4.7%	8.3
Franklin Electric (FELE)	30.14	82%	636	86	\$693	9.0	13.5%	7.9%	11.0
Gorman-Rupp (GRC)	26.64	87%	260	36	\$445	11.4	13.8%	10.7%	12.5
Insituform (INSU)	21.58	76%	798	97	\$826	8.7	12.2%	7.6%	10.2
ITT Corporation (ITT)	46.95	81%	10980	1570	\$8,639	6.0	14.3%	17.2%	12.4
Layne Christenson (LAYN)	24.32	69%	893	89	\$474	4.9	10.0%	1.5%	6.7
Lindsay Manufacturing (LNN)	34.32	72%	345	42	\$429	8.6	12.2%	9.8%	10.6
Mueller Water (MWA)	3.91	65%	1350	83	\$602	14.5	6.1%	-17.0%	4.0
Nalco (NLC)	22.84	78%	3840	692	\$3,152	8.7	18.0%	14.6%	14.5
Northwest Pipe (NWPX)	17.89	43%	390	48	\$165	5.1	12.3%	8.4%	9.4
Pentair (PNR)	33.05	84%	2770	372	\$3,272	11.0	13.4%	6.9%	11.4
Tetra Tech (TTEK)	19.53	61%	1390	151	\$1,211	7.3	10.9%	13.5%	10.3
URS Corporation (URS)	39.7	75%	8940	513	\$3,295	6.8	5.7%	7.6%	6.4
Watts Water Tech. (WTS)	29.4	79%	1250	173	\$1,088	6.8	13.8%	5.8%	10.1
Total			36397						

Financial data as of mid-July, 2010

UIM Index: July, 2010 **10.43**

external economic circumstances. If there is one thing that we don't cut back on much during tough times, it is the water that comes out of our taps. For this reason, water utilities in particular are recognized as one of the most dependable and predictable of any publicly traded stocks. And, in turn, all of those product and service firms (illustrated by the firms in our table) that sell things to water utilities are likely to be at least somewhat buffered from sharp economic downturns as well. Hence, from the investor's perspective, while they don't typically have quite the wild swings up (or down) that other stocks may exhibit, water companies are often viewed as a pretty safe bet for the long term.

In terms of individual stock performance during the past two months, most of the companies in our table have been fairly stable, but there are a couple of specific items of note. No sooner did we construct our portfolio of companies to track here than we lost one of them. (This is a typical hazard for water securities analysts; due to the historically rapid rate of mergers-and-acquisitions and consolidation trends, many public companies have disappeared from the exchanges over recent years.) During May, Cascal NV was the subject of a take-over attempt by the Singaporean water firm Sembcorp. Cascal, with a total revenue base approaching \$200 million, provides water and wastewater services to an array of residential and commercial customers in the United Kingdom, China, South Africa, Chile, Indonesia, Panama and the Philippines. Cascal's customers include primarily homes and businesses representing a total population of approximately 4.6 million. Sembcorp Industries Group is a major Singaporean provider of electrical power and water services, with customers in Singapore, China, India, Vietnam, the United Kingdom, Oman and the United Arab Emirates. The group has total assets of over S\$9 billion and more than 6,700 employees. It is listed on the main board of the Singapore Exchange, and is a component stock of the widely cited Straits Time Index. This acquisition was completed in July, and Cascal will cease trading as an independent public company in early August. We'll be looking for a new company to include in the table next time.

In other developments, Energy Recovery Inc. showed a significant downturn in performance during the period. After the early May announcement of its first quarter earnings, ERI's stock took a substantial dip, from around the \$6 to \$7 level where it had been trading for months, down to just above \$3 per share. In terms of our performance index, that caused ERI's Enterprise Value/EBITDA value to fall substantially, and hence its Performance Index ranking to decline from about 19 down to 14.7. However, the company has an interesting

new technology for recovery of some of the energy utilized in the desalination process, and seems likely to be a significant future player.

Northwest Pipe is a manufacturer of large-diameter, high pressure steel pipeline systems for use in water infrastructure applications, primarily related to drinking water systems. Its pipeline systems are also used for hydroelectric power systems, wastewater systems and other applications. Late last year, the company identified potential accounting irregularities in terms of revenue recognition in prior years, and requested a delay in the reporting of its third quarter 2009 results. The firm later had to suspend its public reporting and it is now in discussions with the S.E.C. regarding the delisting of its stock from the NASDAQ Exchange. Hence, there is no current financial information publicly available for the company, and therefore we have had to utilize the same (now somewhat out-of-date) information here as we presented in the last table (from the May/

June issue of *UIM*). During the last six months, the company's stock has fallen by about 50 percent, from a range of \$40 per share to a current level which is fluctuating around \$20 per share.

Individual companies will always have their individual circumstances — positive or negative — and those circumstances will be reflected in their stock price. However, a rising tide tends to lift all boats, and — without mixing too many metaphors here — the “tide” of the water industry seems to be rising. Given the urgency of water challenges in many parts of the world, and the generally dilapidated state of water infrastructure, it seems a safe bet that demand will remain strong for the vital services which water companies provide. In turn, it's a pretty safe bet that these companies will hence remain strong investment opportunities, irrespective of fluctuating external economic conditions.

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[EDITOR'S NOTE: This regular column tracks and evaluates the performance and future potential of 20 key publicly traded water companies. In each issue, Maxwell presents key investment data, and summarize major investment opportunities and strategic trends in the broader water industry.]

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