By Steve Maxwell

Water Dollars

[EDITOR'S NOTE: Welcome to our first installment of the "Maxwell Report." In this regular feature going forward, water industry consultant Steve Maxwell will be tracking and evaluating the performance and future potential of 20 key publicly traded water companies. In each issue, he will present key investment data and summarize major investment opportunities and strategic trends in the broader water industry.]

Trying to define and identify the best-performing companies in any industry begs many subjective questions, and obviously requires a number of qualitative assessments. The process is biased by intangible assumptions, value judgments and simple differences in data interpretation. For example, many pundits seem obsessed with top-line growth; many surveys consider the "best" companies to be those that are growing the fastest – a reflection of the old maxim that "if you're not growing, you must be dying." However, there is no clear evidence, at least in the water business, that larger size necessarily leads to greater profitability.

From the perspective of investors, top performers are those that demonstrate the most rapidly appreciating stock value – and those are not always the firms that have shown the strongest actual financial performance. Certain firms, and certain sectors of the business, tend to come in and out of favor from time to time, and sometimes equity valuations may be reflective of current sectoral trends or the latest investment fad, rather than actual individual financial performance. Certainly many water companies have been riding a crest of high relative valuations – at least until late 2008 – which are perhaps more reflective of intense investor interest than of individual performance.

Employees are more interested in which companies seem to be the best places to work, offer the best benefits or provide the best career opportunities. All in all, it is not simple to design a comprehensive and quantitative model that takes all of these different factors into account. However, our experience over many years has shown that – at least over the longer term – many of these qualitative factors do in fact tend to go hand-in-hand. Companies that are more profitable and dynamic usually tend to be more enjoyable places to work, more profitable companies tend to have relatively higher stock values, and so on.

WATER DOLLARS

Company	Price	% of 52-wk hi	Revenue	EBITDA	Market Cap.	Enterprise Val/ EBITDA	EBITDA/ Revenue	ROE	Performance *UIM* Index
Ameron (AMN)	68.96	75%	510	62	$634	8.3	12.2%	6.2%	9.8
Badger Meter (BMI)	38.95	87%	250	50	$584	11.6	20.0%	21.0%	17.7
Calgon Carbon (CCC)	17.09	100%	412	73	$957	12.6	17.7%	13.9%	15.4
Cascal NV (HOO)	7.34	99%	171	59	$228	7.4	34.5%	15.2%	22.5
Dionex (DNEX)	74.66	96%	388	90	$1,344	14.2	23.2%	24.2%	20.7
Energy Recovery (ERII)	6.16	70%	47	7	$314	36.6	14.9%	3.2%	19.1
Federal Signal (FSS)	9.75	98%	753	50	$478	13.2	6.6%	5.7%	8.4
Franklin Electric (FELE)	30.65	89%	626	80	$705	9.6	12.8%	7.1%	10.7
Gorman-Rupp (GRC)	25.25	85%	266	35	$429	11.4	13.2%	10.9%	12.2
Insituform (INSU)	26.95	95%	727	90	$1,051	11.8	12.4%	6.7%	11.1
ITT Corporation (ITT)	53.94	95%	10900	1520	$9,817	6.6	13.9%	18.8%	12.7
Layne Christenson (LAYN)	25.21	72%	869	80	$479	5.4	9.2%	-2.7%	5.7
Lindsay Manufacturing (LNN)	40.7	86%	309	32	$529	14.4	10.4%	6.9%	10.9
Mueller Water (MWA)	4.82	81%	1370	94	$742	14.6	6.9%	-91.0%	(10.4)
Nalco (NLC)	24.76	93%	3750	662	$3,417	9.4	17.7%	14.0%	14.4
Northwest Pipe (NWPX)	21.96	52%	390	48	$202	5.9	12.3%	8.4%	9.6
Pentair (PNR)	36.08	99%	2690	350	$3,572	12.5	13.0%	5.9%	11.4
Tetra Tech (TTEK)	23.43	73%	1400	154	$1,453	9.0	11.0%	14.9%	11.2
URS Corporation (URS)	51.29	97%	9250	541	$4,308	8.1	5.8%	7.2%	6.8
Watts Water Tech. (WTS)	31.1	94%	1230	160	$1,144	7.8	13.0%	4.8%	9.8
Total			**36308**						

Financial data as of mid-April, 2010

***UIM* Index: May, 2010** **10.05**

Strange though it may seem for such a vibrant and booming industry, it's actually difficult to find very many large, publicly traded companies in the United States that are more or less pure water plays. Nonetheless, the 20 companies that we will cover here span a good cross-section of different water sectors, and almost all of them derive the bulk of their revenue from water-related activities. In coming months, we'll discuss each of these companies in more detail. (We have specifically excluded the water utility companies here, even though many of them represent excellent long-term investment opportunities, because we believe that – as regulated natural monopolies – their basic economic and financial characteristics are significantly different from the water equipment and service providers shown here.)

In each issue we will show a number of key financial performance metrics in the accompanying table, and we will also track the results of a simple model to monitor and track the overall performance of water companies. In this ranking metric, which we have dubbed the *UIM* Performance Index, performance will be evaluated based upon what we think are three of the most important attributes of a successful company:

1) The ability to generate profits as a function of selling a product or service – the amount of profit generated on a given level of sales – which we measure here by dividing EBITDA (earnings before interest, taxes, depreciation and amortization – a common approximation of operating cash-flow) into total revenues

2) In addition, the ability to effectively utilize capital in the generation of those profits, as measured by return on equity – net income divided by equity capital invested – a metric that will tend to rise, independent of profits, as the capital structure becomes more weighted towards debt; and

3) Finally, the ability to not only generate strong financial performance with an optimal capital structure, but also the ability to recognize and navigate strategic trends and developments in the industry, so as to grow and position one's company so as to maximize shareholder value – measured here by the enhanced version of the traditional price/earnings ratio, the enterprise value to EBITDA ratio.

Based upon our (admittedly subjective) view of the relative criticality of each of these metrics, in our ranking model we have weighted them at 50, 20 and 30 percent, respectively. Finally, we have combined the individual performance index for each of the 20 firms, weighted by revenues, to derive an overall industry performance metric. We will track this water industry performance index over time as well – as a proxy measure of the strength and performance of the water industry as a whole.

As we will undoubtedly see in the coming months, these performance measures will change over time. A couple of quarters of poor earnings or a one-time asset write-down can impact the company's EBITDA and ROE for several quarters. The return on equity figure can actually be higher for less profitable firms that may have dangerously high leverage. Some relatively weaker performers may be rewarded with a higher market valuation due to greater investor interest in their particular sector. The list goes on. It is our hope that this column, in the coming months and years, will provide not only interesting data and metrics for the water industry observer or investor, but also a concise summary of key trends and new developments in this rapidly growing and critical industry.

Steve Maxwell is Managing Director of TechKNOWLEDGEy Strategic Group (TSG), a Boulder, Colo.-based management consultancy specializing in merger and acquisition advisory services, and strategic planning for the commercial water and environmental industries. Maxwell is author of the annual *Water Market Review*, and is also the editor of a recent book titled *The Business of Water*. He is an active participant in the water industry, serving on various private and non-profit boards, and he speaks and writes widely on water resource issues. He has advised dozens of water firms on strategy and transactional issues, and can be reached at (303) 442-4800 or *maxwell@tech-strategy.com*.