

Water Sector: Flash Update

Privately-held water E&C bellwethers see U.S. municipal channel continuing to accelerate; Plus other take-aways from our recent investor call.

Summary: Last week, we hosted an investor call with senior leadership from two of the water sector's most prominent companies, Cindy Wallis-Lage of Black & Veatch and Marshall Davert of MWH Global. These two privately-held entities are among the largest engineering firms in the water and wastewater space, and both companies say that they see the U.S. municipal market exhibiting strong improvement in project activity from a year ago, with the current opportunity set suggesting that this recovery will not only be sustained going forward, but accelerate into 2016. Below are some of the key take-aways from our call with Black & Veatch and MWH.

- **Project funnels suggest U.S. muni channel accelerating.** With \$2 billion in combined annual sales in the water space, Black & Veatch and MWH Global are valuable barometers of the industry's outlook, and both companies are seeing strong improvement in the U.S. muni channel in particular. Black & Veatch's current project funnel is up 30% from a year ago, while MWH Global's book-to-burn ration is currently at 1.6-to-1.0 (anything over 1.0 is bullish), and both companies are tracking \$4 billion in fee opportunities, a fourfold increase from a year ago.
- **Key drivers for muni rebound include R&R, technology upgrades.** Among the drivers cited in explaining the notable rebound in water/wastewater project opportunities were rebounding repair and replacement spending (due to a combination of stable enterprise account financing and pent-up demand) and the upgrade of treatment facilities to incorporate the latest technology as environmental regulations continue to tighten. The ongoing shift toward design-build projects is also a tailwind, since these tend to put upward pressure on project values.
- **California projects slow to develop as utilities remain in “denial”.** Ironically, the demand rebound comes despite the fact that water supply projects in California have been slower than expected in materializing (in spite of this being a supposed key investment theme in the space). California water utilities appear to be in “denial”, believing the drought will run its course, and proceeds from targeted bond issues have been slow in making into actual projects.
- **“Perverse” preference for multiple bids makes adding value key.** Water utilities “go to great pains to be inefficient” in equipment procurement, ignoring the benefits of standardization in a defensive attempt to avoid accusations of playing favorites. As a result, OEMs must truly be ahead of the curve on innovation to avoid falling victim to low-bid margin and pricing pressure. This is another key reason why water equipment and technology appears likely to increasingly become a space where timely innovation can drive notable share gain *in dollar terms*.
- **Shift back toward fixed rates an ironic byproduct of conservation success.** The concept of variable rates is practically sacrosanct in the water space, with the view being that volumetric charges incentivize conservation. Unfortunately, as conservation (helped along by prominent droughts) picks up steam, water utilities relying on variable rate structure are experiencing top-line pressure, creating infrastructure funding challenges. This is driving a shift back to fixed rates (or at least a swing back toward fixed rates in hybrid structures) among utilities.
- **Greenfield projects finally ticking up as construction starts improve.** So far, the recovery in the U.S. muni space has been driven by brownfield projects, as water/WW utilities shore-up distribution systems and modernize existing treatment facilities. As construction starts improve, however, more and more of the project funnel appears to be driven by greenfield projects as municipalities ready the water infrastructure to support new commercial sites and residential developments. This sets the stage for a long-tailed recovery in the municipal channel.

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Water | Environment

Coverage Universe

Advanced Drainage Systems, Inc.
WMS-\$30.52-Outperform; TP: \$32.00

AO Smith Corp.
AOS-\$68.90-Outperform; TP: \$75.00

American Water Works, Inc.
AWK-\$51.96-Outperform; TP: \$58.00

Badger Meter Inc.
BMI-\$57.92-Neutral

Flowserve Corporation
FLS-\$42.70-Neutral

The Gorman-Rupp Company
GRC-\$23.39-Outperform; TP: \$27.00

Lindsay Corporation
LNN-\$74.03-Neutral

Mueller Water Products, Inc.
MWA-\$8.44-Outperform; TP: \$12.00

Pure Technologies Ltd.
PUR.TSX-CN\$5.98-Outperform; TP: CN\$10

Valmont Industries, Inc.
VMI-\$103.41-Neutral

Watts Water Technologies, Inc.
WTS-\$52.83-Outperform; TP: \$60.00

Xylem, Inc.
XYL-\$32.49-Outperform; TP: \$42.00

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