

December, 1, 2017

## American States Water Company: AWR

Niall McGeever

Sector: Utilities

Industry: Water Utilities

Current Price: \$56.79

Target Price: \$60.62

**Company Description:** American States Water Company, through its subsidiaries, provides water and electric services to customers in the United States. It operates through three segments: Water, Electric and Contracted Services. American States Water Company serves approximately 285,000 customers throughout California. American States Water Company operates a Contracted Services division that serves 11 military bases in the United States.

### BUY/HOLD/SELL

Current Price:	\$56.79
Target Price:	\$60.62
Market Cap:	2.1 B
Dividend Yield:	1.75%
ROIC:Y:	8.43%
WACC:	6.69%
ROE:	12.20%
OPM:Y:	26.31%

### Catalysts:

- Short Term(within the year): The increase in water and electric rates being approved by the CPUC
- Mid Term(1-2 years): Increase in revenue from the Fort Riley Contract
- Long Term(3+): New contracts for U.S. Military bases from the U.S. Government



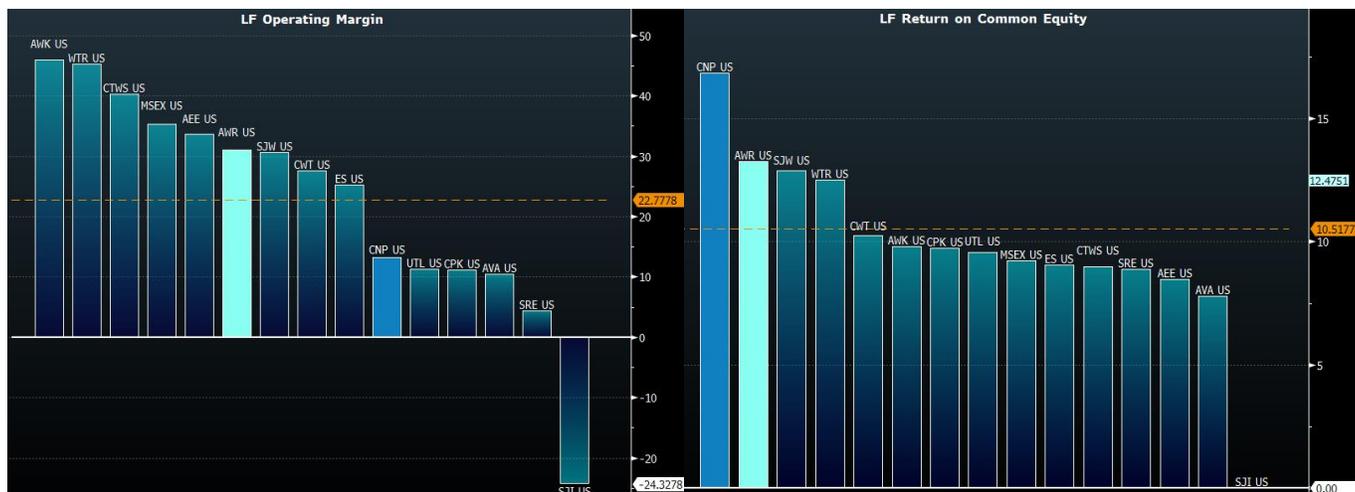
Source: Bloomberg

## Thesis:

American States Water Company will continue to increase their revenue through both of their segments. Golden State Water Company will continue to increase their revenue through new water and electric contract agreements that will be implemented January 1, 2018. American States Utility Services will continue to increase their revenue by adding more United States Military bases to their management portfolio. With both segments set for an increase in revenue, AWR's stock price will increase in the short and long term.

## Earnings Performance:

American States Water Company is most affected by revenue. In the third quarter earnings call, American States Water Co. recorded revenue of \$124.42 million, which increased 0.5% year over year. This missed earnings estimates by \$21.36 million. This was a large miss but can be attributed a new rates decision in 2016 and the sale of the Ojai water system. AWR recorded a downward adjustment of \$5.2 million because of the rates decision issued in December 2016. The Ojai water system was sold to Casitas Municipal Water District for \$34.4 million to resolve Eminent Domain Action. As a result of the sale, AWR has lost revenue from no longer operating this system. However, several positives can be taken out of the earnings call. The first is that ASUS, a segment of AWR was awarded a 50-year contract at Fort Riley, which is worth approximately \$601 million over the life of the contract and is subject to annual economic price adjustment. The next is that operating expenses decreased by \$2 million in the quarter due to lower construction activity at ASUS. Future revenue performance it expected to pick up in the coming years, which shows that AWR is expanding. AWR has an operating margin of 31, which is above the industry average of 22.78. AWR has a return on common equity of 13.26, which is above the industry average of 10.52. While these margins are above industry average AWR can still do better by continuing to cut costs. I expect AWR to improve their margins and exceed earnings in the next periods, which will increase the stock price.



Measure	Revenue					
	2014	2015	2016	2017	2018	2019
Q1 Mar	101.95M	100.93M	93.53M	98.81M	102.50M	106.50M
Q2 Jun	115.64M	114.62M	111.95M	113.20M	120.00M	125.50M
Q3 Sep	138.33M	132.98M	123.81M	124.42M	136.00M	143.00M
Q4 Dec	109.88M	110.12M	106.80M	121.00M	110.50M	115.50M
Year	465.79M	458.64M	436.09M	454.75M	472.00M	495.67M
Cal Yr	465.79M	458.64M	436.09M	454.75M	472.00M	495.67M

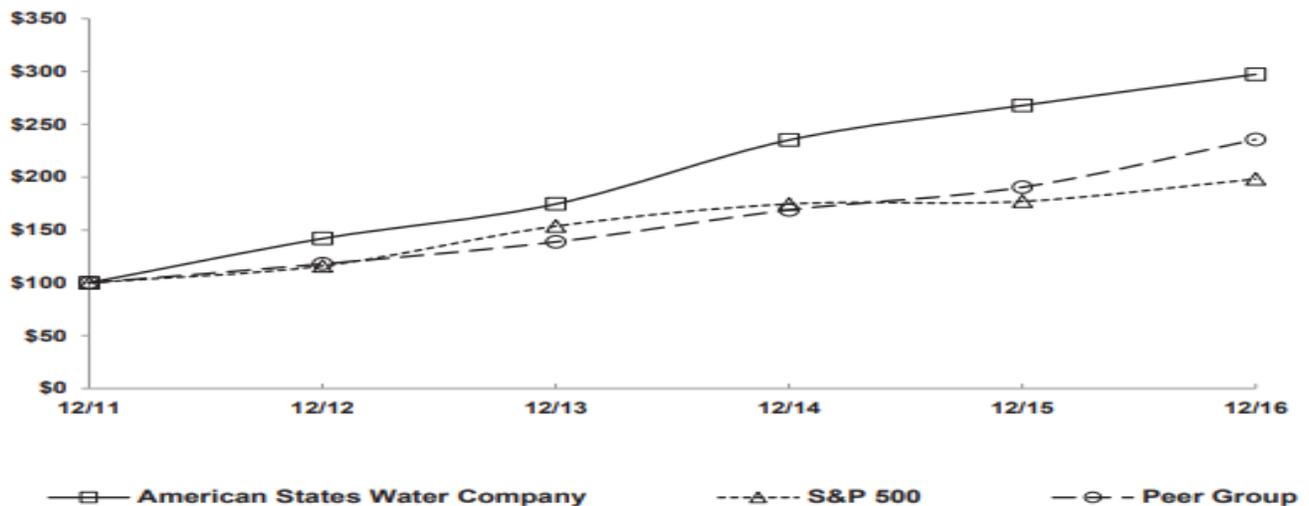
(Fiscal Period: Reported, Estimated)

Source: Bloomberg

### Industry Outlook:

American States Water Company is well positioned in the water utility industry because of the locations that they currently serve. Under California state law, AWR can operate in their service areas with minimal interruption from competitors. California statutory laws provide that no other investor-owned public utility may operate in the public utilities' service areas without first obtaining from the regulator a certificate of public convenience and necessity. With this statute in place, it is extremely difficult for a competitor to enter the space thus making AWR's pumps, distribution facilities and reservoirs valuable. The water utility business is capital-intensive because of the repairs that must be made for aging infrastructure. AWR is maintaining their water systems to avoid more costly expenditures such as broken pipes. AWR plans to spend between \$110 and \$120 million on capital improvements. From 2011 to 2015, the S&P 500 has increased from \$100 to \$198 and peer group has increased from \$100 to \$235. Over the same time period, AWR has outperformed both of these indexes by returning \$297. This shows that AWR continues to grow and add value as a company.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***  
Among American States Water Company, the S&P 500 Index, and a Peer Group



Source: AWR 10K

## Segment Breakdown:

AWR is broken down into two segments: Golden State Water Company (GSWC) and American States Utility Services (ASUS). Within GSWC, there are water and electric segments. The water segment serves approximately 261,000 customers and the electric segment serves approximately 24,000 customers for 285,000 customers. Both segments have retained relatively the same percentage of revenue. In the last fiscal year, the Water Segment decreased 2.1% while the Electric Segment grew 0.3%. The water segment makes up the majority of the revenue. AWR operates an expansive network of pumps, distribution facilities and reservoirs as seen on the chart below. With continued a continued expansion of this network, revenue should increase.

Pumps		Distribution Facilities			Reservoirs	
Well	Booster	Mains*	Services	Hydrants	Tanks	Capacity*
247	399	2,825	261,059	26,065	147	115,765 (1)

Source: AWR 10K

The growth in AWR should be in the contracted services industry. With new contracts up for United States Military bases in the United States, AWR is likely to be in prime position to win these contracts. ASUS could make up to 40% of revenue in the coming years.

In Millions of USD except Per Share 12 Months Ending	FY 2013 12/31/2013		FY 2014 12/31/2014		FY 2015 12/31/2015		FY 2016 12/31/2016	
Revenue	472.1	100.0%	465.8	100.0%	458.6	100.0%	436.1	100.0%
GSWC	358.5	75.9%	361.1	77.5%	364.6	79.5%	338.7	77.7%
Water	320.1	67.8%	326.7	70.1%	328.5	71.6%	302.9	69.5%
Electric	38.4	8.1%	34.4	7.4%	36.0	7.9%	35.8	8.2%
ASUS- Contracts	113.5	24.1%	104.7	22.5%	94.1	20.5%	97.4	22.3%

Source: Bloomberg

## Contracted Services:

The contracted services segment is where the growth is for AWR. Currently, ASUS provides water and/or waste water utility services to 11 military bases, including the four biggest in the United States. The most recent contract that ASUS received from the United States was the contract for Fort Riley, which is for 50 years, valued at approximately \$601 million, and is subject to annual economic price adjustment. ASUS will expect to assume operations in 2018 after a six-to-twelve month transition period. This is going to drive revenue because it is a large contract that is guaranteed for 50 years as long as ASUS maintains its end of the agreement. AWR expects this contract to contribute earnings of \$0.03 to \$0.05 per share starting in 2019. ASUS assumed operations of Eglin Air Force base in Florida in June 2017.



This contract was for 50 years and \$702 million. This shows that ASUS has the trust of the United States by continuing to win contracts for their military bases. ASUS is involved in various stages of the proposal process at a number of other bases considering privatization. Winning these contracts will drive revenue growth because they are large contracts. The U.S. Government is expected to release additional bases for bidding over the next several years so ASUS should be in prime position for the contracts because of their current relationship with the U.S. Government. The CEO of AWR, Robert Sprowls, said in the last earnings call that he expects ASUS will represent between 30 and 40% of AWR in the future. This shows that this segment is growing and profitable.

## Ownership Summary:

The insider ownership has remained the same year over year. This shows that insiders are confident in the growth of the company and as a result are not selling off shares of the company.

Compare Current Stats Against		11/28/16	
Insider		11/27/16	Curr
1) % of Shares Held		1.44	1.44
			Change
			0.00

The ownership in AWR has not had any drastic changes in the last year. The most significant change in ownership of stocks is that Governments have reduced their shares by 1.45%. This is relatively insignificant because to start the year they only held 1.79% of outstanding shares. When they sold off shares, it has not dropped the stock price. A Corporation and Sovereign Wealth Fund have both entered the ownership structure thus showing that they see a potential for growth while owning a relatively safe stock. Pension funds, insurance companies, corporations, banks and sovereign wealth funds have all increased positions thus showing a stable investment. I expect the stock to increase in price.

Compare Current Stats Against		11/28/16	
Ownership Type		11/27/16	Curr ↓ Change
11) Investment Advisor		87.24	86.34 -0.90
12) Hedge Fund Manager		4.50	4.24 -0.26
13) Pension Fund		2.33	2.55 +0.22
14) Individual		1.91	1.90 -0.01
15) Insurance Company		1.16	1.42 +0.26
16) Corporation			1.05
17) Bank		0.55	0.86 +0.31
18) Sovereign Wealth Fund			0.69
19) Government		1.79	0.34 -1.45
20) Brokerage		0.30	0.30 0.00
21) Venture Capital		0.12	0.15 +0.03

Source: Bloomberg

## AWR vs. Competitors:

AWR has mostly above average margins. AWR is good at creating value. It is important to note that their ROIC is higher than their WACC, which means that the projects they are investing in are creating value for the company. It is also important to note that their ROE of 12.20% is higher than the industry average of 9.68%. The one concern could be that revenue growth was negative last year. However, this can be nullified because revenue growth is positive this year and is expected to grow in the coming years. Their operating margin is on par with its competitors. I expect the operating margin to increase once AWR fully implements all their cost-cutting measures. This chart shows that AWR is in the upper class of the water utilities industry.

Name (BICS Best Fit)	Mkt Cap (USD)	Last Px	Rev - 1 Yr Gr:Y	EPS - 1 Yr Gr:Y	P/E	ROE	Dvd 12M Yld	ROIC:Y	WACC	OPM:Y
Median	2.14B	56.67	2.73%	6.62%	31.30	9.68%	1.88%	6.39%	5.81%	26.31%
100) AMERICAN STATES WATER...	2.08B	56.67	-4.92%	1.25%	33.71	12.20%	1.75%	8.43%	6.69%	26.31%
101) CHESAPEAKE UTILITIES C...	1.39B	84.85	8.63%	6.62%	31.72	9.68%	1.48%	7.13%	6.53%	16.83%
102) MIDDLESEX WATER CO	732.96M	44.84	5.46%	13.11%	35.87	9.23%	1.91%	7.40%	7.71%	30.57%
103) CALIFORNIA WATER SERV...	2.14B	44.60	3.57%	8.15%	31.36	10.26%	1.61%	6.33%	6.04%	16.57%
104) AMEREN CORPORATION	15.49B	63.85	-0.36%	4.69%	24.77	8.65%	2.76%	4.49%	4.34%	22.73%
105) AMERICAN WATER WORKS...	15.98B	89.57	4.53%	6.56%	31.35	9.52%	1.81%	4.83%	4.90%	34.37%
106) AQUA AMERICA INC	6.54B	36.79	0.70%	9.58%	27.76	12.51%	2.15%	8.59%	5.65%	39.62%
107) CONNECTICUT WATER SV...	744.01M	61.65	2.73%	3.79%	29.94	9.00%	1.88%	6.39%	5.81%	29.42%
108) AVISTA CORP	3.35B	52.00	-2.85%	14.51%	25.85	7.87%	2.72%	4.89%	4.97%	20.09%
109) SJW GROUP	1.38B	67.20	11.35%	19.54%	31.30	10.29%	1.55%	7.16%	6.30%	27.41%

Source: Bloomberg

## Rate Increases:

In July 2017, Golden State Water filed its water general rate case application with the California Public Utilities Commission (CPUC). This will determine new water rates for the years 2019, 2020 and 2021. GSWC has requested an application average of \$125 million per year for capital budgets. In the last earnings call, operating cash flows for the year increased to \$120.2 million from \$77.5 million. This is partially due to CPUC-approved surcharges. This shows that GSWC has a good working relationship with the CPUC so that they can regain higher revenue with surcharges in peak times. GSWC also filed its water cost to capital application in April. The application recommends an overall weighted return on rate base of 9.11%, including an updated cost of debt of 6.6% and a return on equity or ROE of 11%. The current authorized return on

rate base is 8.34% including an ROE of 9.43%. A decision on this should be made before the end of the year and would be implemented January 1, 2018. GSWC also filed their electric general rate case for the years 2018-2021 in May. A decision on this is expected before the end of the year and would be implemented January 1, 2018. With both segments for GSWC up for renewal rates at the end of the year, this is an opportunity for GSWC to increase their revenues.

## Sum of the Parts Analysis:

After breaking down American States Water Company into three segments, I found the market multiples for comparable companies for each segment. The current segment that trades at the highest multiples is the water segment followed by the electric segment and lastly the contracted services segment. The multiples show that AWR is trading within the low and high multiple range. AWR will increase their revenue in the coming years, which will raise the stock price towards the high of \$66.73.

Segment	Method	Value	EV/EBITDA		EV			Comparable
			Multiple		Low	Average	High	
			Low	High				
GSWC Water	LTM EBITDA	123.7	15.87	19.14	1963.119		2367.618	WTR
GSWC Electric	LTM EBITDA	9.9	8.3	14.76	82.17		146.124	CNP
ASUS	LTM EBITDA	19.9	7.31	12.68	145.469		252.332	MTZ
<b>Total Firm Value</b>					2190.758		2766.074	
<b>Less: Net Debt</b>					-360.6		-360.6	
<b>Plus: Proceeds from In the Money Options</b>					36.8		36.8	
<b>Total Equity Value</b>					1866.958		2442.274	
<b>Diluted Shares Outstanding</b>					36.8		36.8	
<b>Equity Value</b>					\$50.73	\$58.55	\$66.37	
<b>Current Price</b>					\$57.12		\$57.12	

Source: Author's Excel

## Conclusion:

In conclusion, I am proposing a BUY for American States Water Company (AWR). AWR is well positioned in all their market segments. The increase in rates in 2018 will drive revenue further. With ASUS set to take over Fort Riley in the coming months, ASUS has made themselves the premier contract service provider for the United States Military. With new military contracts coming out in the coming years, ASUS has a clear advantage to win these contracts. AWR's margins are above the industry average. A target price of \$60.62 can easily be achieved.

**American States Water Company (awr)**

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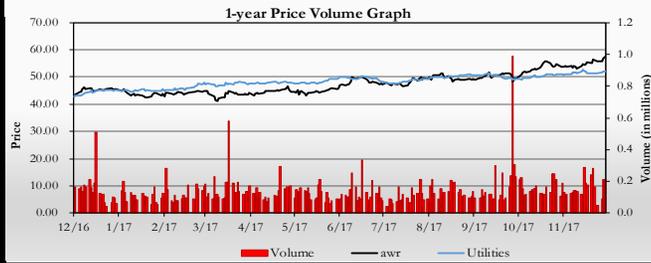
**NEUTRAL**

Analysis by Niall McGeever  
12/1/2017

Current Price: **\$56.76**  
Divident Yield: **1.9%**

Intrinsic Value: **\$59.42**  
Target Price: **\$60.62**

Target 1 year Return: 8.7%  
Probability of Price Increase: 87%



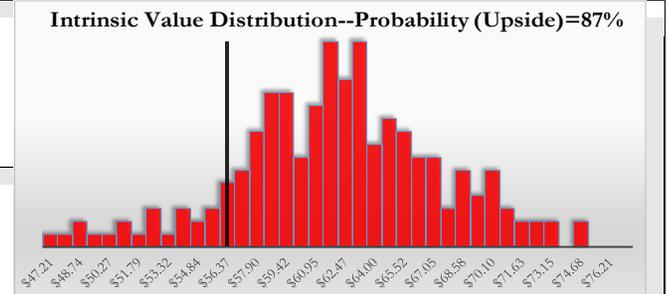
**Description**  
American States Water Company, through its subsidiaries, provides water and electric services to residential, industrial, and other customers in the United States.

General Information	
Sector	Utilities
Industry	Water Utilities
Last Guidance	November 3, 2015
Next earnings date	February 23, 2018
Estimated Country Risk Premium	5.27%
Effective Tax rate	24%
Effective Operating Tax rate	24%

Market Data	
Market Capitalization	\$2,116.02
Daily volume (mil)	0.08
Shares outstanding (mil)	36.68
Diluted shares outstanding (mil)	36.80
% shares held by institutions	116%
% shares held by investments Managers	60%
% shares held by hedge funds	3%
% shares held by insiders	1.43%
Short interest	1.93%
Days to cover short interest	4.21
52 week high	\$58.11
52-week low	\$41.14
Volatility	20.52%

Past Earning Surprises		
Quarter ending	Revenue	EBITDA
9/30/2016	-8.97%	N/A
12/31/2016	-14.69%	-17.19%
3/31/2017	7.29%	7.71%
6/30/2017	-5.06%	-8.39%
9/30/2017	-14.65%	-18.15%
Mean	-7.22%	-9.01%
Standard error	4.1%	6.0%

Peers	
California Water Service Group	
Aqua America, Inc.	
SJW Group	
American Water Works Company, Inc.	
Middlesex Water Company	
Connecticut Water Service, Inc.	
Artesian Resources Corporation	

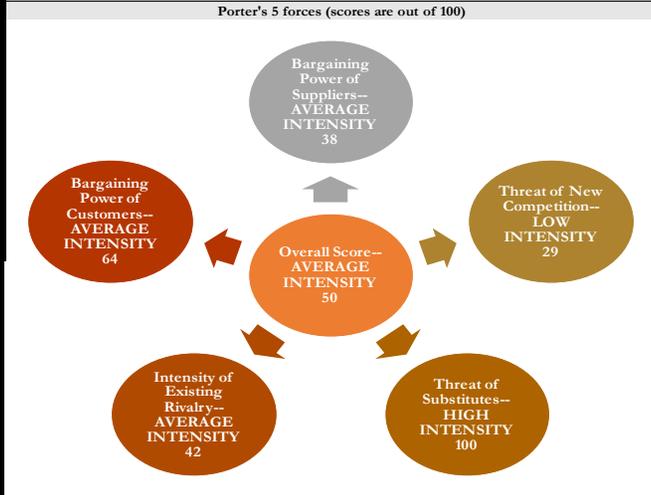
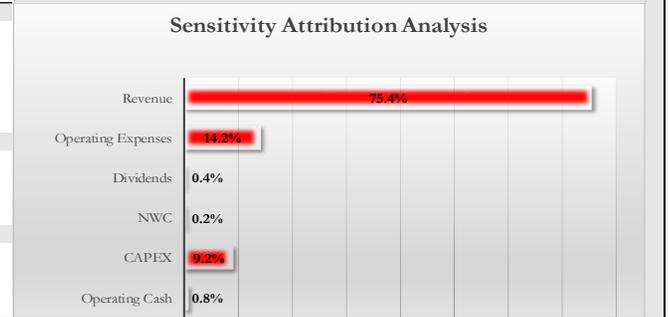


Management	
Position	CEO, President & Director
Sprows, Robert	CFO, Principal Accounting Of
Tang, Eva	Senior Vice President of Reg
Kruger, Denise	Vice President of Water Oper
Scanlon, Patrick	SVP of American States Utili
Cotton, James	Vice President of Management
Gallagher, James	

Total compensations growth		Total return to shareholders	
17.58% per annum over 5y	6.83% per annum over 5y	3.37% per annum over 5y	3.37% per annum over 5y
0.89% per annum over 5y	-1.07% per annum over 5y	3.37% per annum over 5y	0% per annum over 0y
N/M	N/M	N/M	N/M

Profitability		Invested Funds	
Return on Capital (GAAP)	8.0%	awr (LTM)	awr (5 years historical average)
Operating Margin	16%	Cash/Capital	-5.6%
Revenue/Capital (GAAP)	0.51	NWC/Capital	4.6%
ROE (GAAP)	13.7%	Operating Assets/Capital	100.8%
Net margin	13.5%	Goodwill/Capital	0.1%
Revenue/Book Value (GAAP)	1.01	Capital Structure	awr (LTM)
		Total Debt/Market Capitalization	0.46
		Cost of Existing Debt	5.9%
		CGFS Rating (F-score, Z-score, and default Probability)	B
		WACC	10.4%

Peers' Median (LTM)	
7.81%	5.34%
12.84%	15.31%
0.61	0.35
13.1%	9.6%
12.6%	15.5%
1.04	0.62
3.0%	5.4%
3.6%	-3.0%
93.3%	95.2%
0.1%	2.5%
0.44	0.48
6.6%	4.3%
BBB	BB
10.4%	7.8%



Period		Revenue Growth Forecast	
Base Year	1%	NOPAT Margin Forecast	22.0%
9/30/2018	23%	Revenue to Capital Forecast	0.56
9/30/2019	20%		0.61
9/30/2020	17%		0.76
9/30/2021	5%		1.16
9/30/2022	1%		6.39
9/30/2023	1%		-2.34
9/30/2024	1%		-1.09
9/30/2025	2%		-0.71
9/30/2026	2%		-0.53
9/30/2027	2%		-0.42
Continuing Period	2%		-0.35
			-0.30

Period		Return on Capital Forecast		WACC Forecast	
Base Year	12.3%			10.0%	
9/30/2018	11.5%			10.0%	
9/30/2019	11.0%			9.8%	
9/30/2020	10.8%			9.7%	
9/30/2021	11.0%			9.6%	
9/30/2022	11.0%			9.5%	
9/30/2023	11.0%			9.5%	
9/30/2024	11.0%			9.5%	
9/30/2025	11.0%			9.5%	
9/30/2026	11.0%			9.5%	
9/30/2027	11.0%			9.5%	
Continuing Period	11.0%			9.5%	