



The Case for Investing in Water Industry Stocks

Foreward

Water is by far the most common substance on earth, yet it is in exceedingly short supply. We cannot create water, yet it is infinitely renewable. Water is stupendously under-priced, yet it is the most valuable substance that exists. Water is commonly abused, yet it cannot be destroyed. Water is the only substance that can be a liquid, a solid or a gas: We can change its form, but we cannot duplicate its substance. The supply of water is forever fixed, yet our supplies are diminishing very rapidly. While abusively under-valued, water has no substitute regardless of price, the only element in the world of which this is true: This most fundamentals of facts creates the inexorable and intractable demand for water that will not abate with time.

A Compelling Investment Theme

The water industry is comprised of a vast array of companies providing products and services toward the collection, conveyance, treatment and monitoring/analysis of water and wastewater for multiple purposes and end users. As you will see in the table below, investing in the U.S.-based utility component of this industry has historically worked very well, but the time has come for much broader global exposure in water stocks.

Water is the single most important economic input to the global economy, and more specifically, to individual enterprises. The disparity between supply and demand for clean water is an inexorable problem; yet the relentless demographic demand for its uninterrupted supply makes water by far the most stable of all commodities – unaffected by cyclical influences which constantly badger other more typical input commodities.

This global theme of water insufficiency relative to unrelenting demand, along with all the related trends and opportunities it has spawned, continues to benefit the prospects of a broad range of publicly traded companies which help to provide solutions to this supply/demand dilemma.. A diverse global universe of investment opportunities exists within the theme of water investing; all the while eliminating the typical resistance to sector fund investments, which are far more limited in scope and susceptible to cyclical influences: Water investing is a broad and deep global theme, and is far too diverse to be considered sector investing.

Water Utilities: The Industry Stalwart

U.S. water utilities have generally been the largest core investment group for most water investment portfolios, for the simple reason that U.S. water utilities have been a leading stock market performer for many years. Moreover, dividends have played a large part in these total return figures, which tends to dampen market volatility for these shares.

5 Year Summary-12/31/00 to 12/31/05		
	<i>Total Ret</i>	<i>Annual</i>
Water Utility Stocks*	134.57%	18.59%
S&P 500 Index TR	2.74%	0.54%
Dow Jones Industrial Average TR	10.42%	2.00%
NASDAQ Composite Index	-8.47%	-1.75%

10 Year Summary-12/31/00 to 12/31/05		
	<i>Total Ret</i>	<i>Annual</i>
Water Utility Stocks*	446.01%	18.50%
S&P 500 Index TR	138.29%	9.06%
Dow Jones Industrial Average TR	154.69%	9.79%
NASDAQ Composite Index	118.29%	8.11%

Source: Bloomberg Analytics

*An equally-weighted list of all publicly traded U.S. water utility stocks that existed as of 12/31/05. Importantly, this is a negatively-selected list, in that some public water utility stocks were acquired during the years depicted above, and the returns on those acquired companies, normally purchased at large premiums to market prices, are not included herein. Thus, if this compilation included the returns of all water utility stocks that were trading at the beginning of these periods, the returns would have been substantially higher.

A striking and very illustrative fact is that we have found that in any randomly selected five-year period in the last 25 years (1982-87, 1993-98, 1979-84, etc.) water utilities usually topped the list of the best performing industry groups in the U.S. stock market on a total return basis. Why? The simple answer is that water utilities have always done very well in good times and bad. When compared to any other industry, water utilities have a more obvious and compelling business model with the most persistent demand and probably the most predictable future.

In addition, regular dividend increases tend to keep the stock prices moving ahead on a very consistent and predictable basis. Such regular dividend increases are a hallmark of the water utility group, and are perhaps the best indicator of the quality and stability of any enterprise. It also says a lot about the cash generated by these businesses.

Aqua America (WTR), formerly known as Philadelphia Suburban Corporation, is presently the largest investor-owned American water utility in the US. Its dividend history is not only impressive, but also quite instructive. In November of 2005, the company announced a 10% dividend increase and a 4 for 3 stock split, which represents the 15th increase in 14 years. The company has paid dividends since 1945. The March 1, 2005, payment began the 60th consecutive year of shareholder dividend payments. This stellar record led the company to the number one spot in the performance list below.

Similarly, late in 2005, Southwest Water Company (SWWC), another American water utility, announced a 10% increase in its quarterly dividend and a 5% stock dividend payable in January of 2006. This is the kind of news that Southwest Water investors have regularly enjoyed, and helps to explain why Southwest is second in the 10-year performance list below.

The long-term total return of water utilities continued to be a leader in the U.S. stock market through 2005. Below is a list comparing the ten remaining investor-owned water utilities in the U.S. as compared to a list of popular investment icons.

Keep in mind that this utility list used to be much longer, but many companies beyond the ten now remaining were bought by water-savvy foreign investors over the last ten years, and the list is now much reduced. Thus, the current list is somewhat negatively selected, in that many of the better-performing companies are no longer part of the group and some of the laggards remain.

The following table illustrates a list of widely held American stocks for the most recent 10-year period (12/31/1995 through 12/31/2005).

Symbol	Name	1995 - 2005	
		Total Return	Annualized
WTR	Aqua America Inc	818.50%	24.80%
SWWC	Southwest Water Co.	765.72%	24.09%
SJW	SJW Corp.	412.42%	17.75%
ARTNA	Artesian Resources	411.60%	17.73%
AXP	Amer Express	370.02%	16.72%
YORW	York Water Co.	354.07%	16.34%
WMT	Walmart Stores	351.14%	16.24%
PNNW	Pennichuck Corp.	332.82%	15.78%
HD	Home Depot	302.88%	14.93%
IBM	Intl Bus Mach.	286.71%	14.47%
CWT	California Water Serv	259.59%	13.65%
XOM	Exxon Mobil Corp	257.81%	13.58%
GE	Gen Electric	255.09%	13.49%
AWR	American States Water	248.79%	13.31%
PG	Procter & Gamble	235.15%	12.84%
JNJ	Johnson & Johnson	227.29%	12.57%
CTWS	Connecticut Water Serv	202.07%	11.69%
MSEX	Middlesex Water Co.	196.09%	11.47%
INDU	Dow Jones Indus Avg.	154.69%	9.79%
SPX	S&P 500 Index	138.29%	9.06%
CCMP	Nasdaq Composite	118.29%	8.11%
MCD	McDonalds Corp	65.80%	5.18%
K	Kellogg Co.	47.73%	3.97%
DIS	Disney Co.	32.86%	2.88%
MRK	Merck & Co.	31.70%	2.79%
KO	Coca-Cola Co.	26.35%	2.36%

Source: Bloomberg Analytics - All returns are with dividends reinvested.

The Water Industry - An Extensive and Diverse Global Universe of Companies

We have discussed water utilities up to this point, but it must be strongly emphasized that water utilities are actually only a small part of our investment universe of global water industry stocks. Indeed, the Summit-defined water stock universe stood at 359 companies on 12/31/05, and less than 20% of the list was water utilities. Our emphasis in discussing water utilities was intended to illustrate the remarkable stability at the basic delivery point of the industry, and how all companies participating in the industry's supply and service chain are very positively influenced by this persistency and stability.

SUMMARY BY REGION – DECEMBER 2005

Region	Total Mkt Cap USD	# of Comps	Median P/E	Median EV/EBITDA	Median P/S	Median P/B	Median D/E	Median Div Yld	Median ROE	Median ROE 5YR
Asia & Pacific Rim	\$84,912,970,957	143	18.71	12.17	1.03	1.43	35.80%	1.44%	7.97%	5.95%
Europe & Africa	\$327,259,473,004	95	19.82	8.91	1.08	2.46	61.45%	2.67%	9.93%	9.95%
Latin America & Canada	\$21,954,702,028	18	13.51	10.42	2.41	1.60	43.73%	3.13%	9.22%	7.98%
United States	\$226,907,053,970	103	22.21	10.12	1.09	2.37	46.62%	0.62%	9.69%	9.79%
Total	\$661,034,199,959	359	19.26	10.27	1.08	1.99	45.17%	2.06%	9.46%	8.89%

The non-utility majority of companies on our list are basic water industrial stocks: Companies involved with pumps, pipes, valves, filters, testing, instrumentation, engineering, and construction of water systems. Water utilities are the highly visible point of the spear in the water industry, but the water industrials are the shaft of that spear, and one cannot be effective without the other.

Notice that only 103 of the 359 companies in the chart above are U.S. companies: This is truly a global industry, although it has not been perceived as such by most investors. The over-emphasis on U.S. companies is pointed out by the statistics within the above summary: Note that the valuation numbers for U.S. water equities are well above, while the dividends are well below, those of the rest of the world. We believe that these disparities will be removed by global markets in due course.

As we said earlier, less than 10% of the customers in the U.S. are served by an investor-owned utility, and that number is probably also around 10% on a global basis. However, every water utility, whether owned by a municipality or stockholders, must buy the goods and services necessary to provide uninterrupted service and to provide a regulatory compliant product. Every water utility is a steady customer of the water industrials, and obviously the services of the utility must remain uninterrupted. Therefore, the business order flow to the industrials also has a stable and non-cyclical quality. Indeed, there is a pronounced "trickle-down" effect in the water industry, and that is not just a play on words.

Over the last 25 years, we have found that companies who sell mainly to water utilities have a much more persistent, predictable, and stable business profile than those similar companies who might be selling into more cyclical industries. Thus, a valve maker selling to water utilities is likely to have a much better business than a valve maker selling to the oil industry or to the aircraft industry. Here again, many segments of the water industrial sector are highly localized and fragmented and offer fertile prospects for the benefits of consolidation and privatization.

Water: The Ultimate Supply vs. Demand Story

We have exactly the same amount of water in our ecosystem today as we had 10 million years ago. The difference between then and now is that there are now some 6 billion people competing for this increasingly scarce resource, the supply of which cannot be increased along with population increases. Indeed, global per-capita water supplies do not just decline annually on an arithmetic basis, equivalent to the 2% global population growth, but rather on a geometric basis, which results from these same 6 billion people polluting the increasingly scarce remaining supplies of potable fresh water.

The table below outlines how very rare is the usable supply of fresh water available for human use. Indeed, this number is just a very small fraction of 1% of all the water on the planet, and on a per-capita basis, this supply is declining at an alarming rate.

When considering water supplies, a common error is often made in considering only that amount of daily water that is needed for consumption by each person on earth. But while water is the most basic of human needs for survival, it is followed closely by the need for food, and the most vital input to sustain world food supplies is adequate water resources, which is the key to all world food production.

Taking a moment to consider the table below will help put the water supply and demand equation in some perspective:

Water Source	Water Volume in Cubic Miles	Percent of Total Water
Oceans	317,000,000	97.24%
Icecaps, Glaciers	7,000,000	2.14%
Ground Water	2,000,000	0.61%
Fresh-Water Lakes	30,000	0.009%
Inland Seas	25,000	0.008%
Soil Moisture	16,000	0.005%
Atmosphere	3,100	0.001%
Rivers	300	0.0001%
Total Water Volume	326,000,000	100.00%

The Hydrologic Cycle (Pamphlet), US Geological Survey

Water is the most basic and necessary commodity, and it is the only element in the world that has no substitute at any price. One can substitute wheat for oats, coal for natural gas, corn oil for soybean oil and hydro-electricity for fossil-fuel generated power, but you cannot substitute for water at any price. While abusively under-valued, water has no substitute regardless of price, the only element in the world of which this is true: This most fundamental of facts is another key to the inexorable and intractable demand for water that will not abate with time.

The Key Drivers for Water Investing

No other industry rivals the global water industry in the amount of key drivers propelling the growth of the industry. Indeed, the manifest drivers are each compelling and inexorable, and a full discussion of these factors would require many pages of information. Thus, in the interest of brevity, we have labored below to reduce the discussion of the drivers to an outline form that we hope succeeds in giving the reader a good basis for understanding why we believe the global water industry will be an investment leader for decades to come.

Large Industry Undergoing Dynamic Change: The Water Industry is one of the three largest industries in the world (along with Oil & Gas and Electricity) in terms of assets deployed; however, it still is not well understood by investors, and still has a minority of investor ownership. This ‘under-owned’ factor creates more investor opportunity than is present with other very large, but already investor-dominated, industries. It has been said by some that the global water industry today resembles the world petroleum industry in 1920.

- On 12/31/05, the Summit Water Universe was composed of 359 companies with \$661 Billion of market value. These are the companies that will benefit from the drivers discussed here and these are the companies which will help solve and/or alleviate the world’s water problems. In our view, every serious investment portfolio should own a core group of these stocks over the years to come.
- Although hard data is sparse, it is clear that the fastest growing industry in the world today, in terms of new public equity capitalization coming into investor hands, is the global water industry. This trend is not slowing and is expected to accelerate and persist for many years to come. “The number of people served globally by investor-owned water companies is expected to rise 500% over the next 10 years.” – *Lehman Brothers*.
- Global water utilities currently have the lowest percentage of investor ownership of all forms of utilities, but municipal and/or private ownership is steadily declining as privatization and consolidation advances.

Fixed Supply, Exploding Demand: The supply of fresh water on our planet is no larger today than it was when humans first walked the Earth: There are now more than six billion people globally competing for this finite resource, which is becoming increasingly scarce by means of pollution of sources.

- Available fresh water is well less than 1% of all water on earth: Amazingly, actual the usable/accessible water supply is less than 1/100th of this already minute amount.
- Running water is available to only 20% of the world’s population. Major health problems persist in part due to the fact that 50% utilize unclean water and have no basic sanitary facilities.
- A third of all nations are suffering from water stress. Since 1950 world population doubled but water use tripled: Technological advancements have yet to reduce human dependence on water.

Special Features Of Water Stocks: When compared to any other industry, water has a more obvious and compelling business model with the most persistent demand and probably the most predictable future.

- There is no substitute for water and users cannot postpone purchases; price-inelastic demand.
- Conveyance system to the end user creates a natural monopoly with huge barriers to entry.
- Demand is unaffected by inflation, recession, interest rates, changing preferences, or inventory loss.
- A history of strong and consistent growth under all market or economic conditions.
- Price does not yet reflect real economic value: Huge room/need exists for asset price expansion.

Privatization And Consolidation Gains Momentum: Dilapidated water infrastructure is a key driver forcing a shift toward privatization and consolidation of water utilities around the world. With governments around the world being squeezed for funds, the monetization of the water utility makes good sense and removes a serious burden from municipal funding. Buyers, in turn, acquire solid assets at a fraction of replacement value and which provide excellent cash returns.

- Municipal and private utility operators often do not have the resources to maintain their water systems up to regulatory standards. Politicians and regulators want to “get rid” of the problem that nobody wants to pay for.
- Need to reduce municipal burden encourages water systems to privatize at values favoring the buyer. Which, in turn, is most often an investor-owned company. Privatization very much favors the buyer, and this trend is gathering momentum at an accelerating pace.
- Companies involved in consolidation see good revenue growth within a slower-growing market, and pricing allows attractive returns on capital to the buyer; all while significant cash flow streams are created.
- Water “roll-up” offers growing economies of scale and enhanced prospects of return for investors.

Water Problems in China are Creating a New Opportunity: While markets have avidly bid most “China plays” to premiums, little attention has been paid to the most basic and compelling requirement for the sustained growth of the Chinese economy: Adequate water and sanitation facilities.

- China's per capita water reserves are only about 1/4 the global average, and are only slightly above the water assets of India. Of the 669 cities in the country, 440 suffer water shortages, and 110 of these cities are considered to have reached the critical level
- Companies that can help solve the massive water problems in China are looking at strong demand for years to come.

The Essential Investment Thesis of Water Investing

The global water industry combines the best underlying business model with the most inexorable demand future of any existent industry, and this fundamental fact is not likely to change. Indeed, the water industry has more wind in its sails than any other industry, period. Choosing the best stocks from within this select universe further enhances return potential.

In our view, if one concentrates wholly on a stock universe that represents the highest quality and most dominant investor-owned water stocks in the world (our stock universe of 359 companies) and if one constantly monitors this universe for the best values, the chances for investment success are very good, and the odds for unsatisfactory performance are quite low.

We have spent 25 years of assiduous labor assembling our universe, and our experienced team of water investment specialists knows this list of companies in an in-depth way that we believe is unmatched anywhere in the global investment community.

We have been water investors for a very long time, and we still have never seen an investment theme that comes remotely close to providing the risk-reward characteristics of the global water industry. The industry has certainly evolved over the last 25 years, and the changes are virtually all positive: The outlook for water stocks today is much better than it was 25 years ago, and we have never been as optimistic as we are today about the future of our chosen investment arena.

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