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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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American Water Works (AWK)- EQ Review

Current EQ Rating*	Previous EQ Rating
4+	na

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We are initiating earnings quality coverage of AWK with an EQ Rating of 4+ (Acceptable).

Because the company operates largely as a Regulated Utility company, it has ways to recover costs that run above forecasts such as with pensions or rising interest rates. At the moment, the pension may be a minor headwind on cash flow, but not significant. Interest rates are unlikely to be a headwind. Non-cash AFUDC (Allowance for Funds Used During Construction) is about 5% of earnings and that may tick up further.

AWK's earnings and cash flow are hindered by the new tax law causing regulators to rebate the savings back to customers – this drag should vanish in two more years and that is why we gave the company a plus mark on the rating. The company is also not generating enough cash flow to cover its growth capital spending, which is boosting the debt levels. This needs to be watched but does not appear excessive at this time. Finally, the results from non-regulated business acquisitions are mixed which is adding lumpiness to results along with potential for write-downs that have already been experienced.

- **The current cash flow of about $1.4 billion does not support $1.5 billion in capital spending, $200 million in acquisitions, and $360 million in dividends.**

- **We estimate maintenance capital spending at about $0.5 billion, and by that figure, the cash flow works, there just wouldn't be much growth. The growth investing is being added to the rate base and boosting revenues going forward and will require minimal additional spending. The growth spending and acquisition policy is expected to continue for many years to come.**

- **AWK is covering the spending shortfall by borrowing.** Its debt/capital ratio is ticking up and caused Moody's to downgrade its rating one notch. The ratio is likely to continue rising because **the company is also retaining less of net income due to the rising dividend. Thus, the equity component of the capital base is growing more slowly than debt.**

- **The new 21% corporate tax rate has caused utility commissions to rebate much of the tax savings to AWK back to water customers.** The largest adjustments made to EPS have been related to deferred tax accounts. Also, this has reduced recent growth rates for revenue from 3%-5% to under 1% in 2018.

- **AWK expects the tax rebating situation to cost it $100-$200 million in cash from operations in 2019-2021. That further pressures the company to borrow more to cover growth-related capital spending.**

- **AFUDC is a common practice for utilities whereby they preserve their equity base by posting a non-cash income credit** to offset interest paid on projects being built and not yet earning a return by being in the rate base. **This is still only 5% of AWK's earnings but increasing and the construction of a desalination plant could boost it further.**

- **AWK also wants to grow at a faster rate via non-regulated businesses, while keeping them a smaller part of the overall business. Currently, they are about 15% of the total.**

- **Looking at the last few years, we aren't seeing much growth at all in this area even with some new contracts and acquisitions. It has already exiting one of the units that operated water systems for municipalities and large corporations. It has already written off a large percentage of a 2015 purchase that supplies water to fracking operations.**

- **The latest deals are adding to debt, causing more share issuance, and have high levels of goodwill. It is not clear that the returns are there to support the asset levels.** The Pivotal deal that sells home warranties will need to quadruple earnings in four years to hit guidance by our estimate.

Basic Back Story – American Water's Current Cash Flow Doesn't Support the Model

	1H19	2018	2017	2016	2015	2014
Cash Flow Ops	$480	$1,386	$1,449	$1,289	$1,179	$1,097
Cap-Ex	$712	$1,586	$1,434	$1,311	$1,160	$956
Removals	$41	$87	$76	$84	$107	$78
Acquisitions	$80	$398	$177	$204	$197	$9
Free Cash Flow	-$353	-$685	-$238	-$310	-$285	$54
Dividend	$173	$319	$289	$261	$239	$216

The company's growth story is built heavily on two items: 1) it has a huge amount of very old infrastructure – these can be replaced/modernized to improve safety and reliability and regulators will let them earn a set return on the investment and 2) water and waste-water systems are heavily fragmented and it can continually make tuck-in acquisitions to its network.

On capital spending – American Water sees 5-7% of its growth coming from earning a regulated return on its spending as it modernizes the system. Like a pipeline or other infrastructure company, it often has to build the new system before it starts to get paid. This is called regulation lag. Once it is built, it will earn the higher return for year after year with minimal additional capital spending. So, currently capital spending is considered inflated. However, the company expects to spend $7.3 billion in this area from 2019-23. That's basically $1.5 billion per year. From that level of spending alone, free cash flow will be negative for some time.

Also, as part of the modernization efforts, older systems and abandoned assets have to be removed and cleaned up. This is the removal line above and it is running just under $100 million per year. We also expect this cash outflow to continue.

At the same time, more acquisitions are expected to happen. Many of these are small and represent acquiring more regulated water and waste-water systems in existing AWK states. This allows the company to generate more growth via the purchase, gain a regulated set rate of return, and perhaps reduced overhead costs by folding the new company into its already established network. We'll talk more about acquisitions below, but for now, investors should expect more of this and the company's forecast is to spend $0.6-$1.2 billion in this area for 2019-23 to add 1%-2% to its growth.

While the company's cash flow does not support the current growth model – the focus is to treat growth capital spending as a long-term investment that will drive cash flow for decades. Thus, the argument is that maintenance capital spending is considerably lower. The first way to look at this depreciation vs. capital spending. The last three years' depreciation has been $497 million, $460 million, and $435 million. That compares to total capital spending of about $1.5 billion. We can also look at the company's list of PP&E and average life. This also points to needing just over $500 million per year to maintain the system.

PP&E	2018	Wgt Avg Life	Depreciation
Sources of Supply	$821	47	$17
Treatment Facilities	$3,607	40	$90
Transmission Facilities	$10,164	70	$145
Services/Meters	$4,018	31	$130
Gen. Structures/Equipment	$1,625	15	$108
Waste Collection	$943	60	$16
Waste Treatment	$570	41	$14
Total			$520

In many cases, maintenance spending of these assets has suffered from under-investment for a considerable time. But, pulling out the growth capital spending and acquisitions, the model is $1.5 billion in cash from operations to pay $600 million in capital spending and removals and $360 million in dividends at the current $2/share annualized rate.

How Does American Water Cover this Ongoing Growth Investment – With Borrowing

The company has a cushion to pay for growth out to free cash flow beyond maintenance. However, it is growing even faster because it is borrowing the money:

	1H19	2018	2017	2016	2015
Debt	$9,070	$8,604	$7,725	$7,182	$6,556

The key ratio to monitor here is the debt/capital ratio. The company's maximum level cannot exceed 0.70x. It has risen from 0.55x to 0.60x now. The high capital spending exceeding cash flow caused Moody's to cut the company's debt rating last April. This ratio bears watching:

	1H19	2018	2017	2016	2015
Debt/Capital	0.60	0.59	0.59	0.58	0.56

What is helping to a large degree is earnings exceed the dividend, so the equity balance is rising as part of capital and offsetting some of the increase in debt in the ratio. By issuing more shares in 2018 and raising the dividend – the growth in equity is being reduced. More importantly, they issued 2.3 million shares for $183 million to by Pivotal. Pivotal is not expected to add to earnings early on, and only add $0.12 in 2022, which would be about $20 million in net income. The incremental shares will be adding $4.6 million to the dividend and rising on the way to 2022. The result is equity will likely rise slower than debt and continue to push up the debt/capital ratio:

	1H19	2018	2017	2016	2015
Net Income	$283	$567	$426	$468	$476
Dividend	$180*	327	$297	$267	$244
Retained	$103	$240	$129	$201	$232
% Retained	36.4%	42.3%	30.3%	42.9%	48.7%

- The dividend is paid in the following quarter, in the first half of 2019, only one quarterly dividend payment of $90 million was posted – the annualized rate is $360 million.

In 2018, the company raised $183 million in equity as it financed the Pivotal deal with a 50-50 debt/equity split and announced this would lower the debt/capital ratio. It did – they just kept borrowing more after this deal. American Water is saying it will not need to raise additional equity to fund its plans. Clearly, it will need external capital to pay for acquisitions and growth – so investors should keep an eye on the debt to capital ratio as it appears debt will continue to rise faster than equity.

The Tax Cuts Are Pressuring Growth, Income, and Cash Flow

Because American Water is largely a regulated public utility – much of its revenue is set by various state agencies to ensure a set rate of return on assets that covers all the costs and yields a profit for the company. When the tax cuts were passed in 2017 and the corporate rate was reduced from 35% to 21% – that was a big positive to many companies for earnings and cash flow. We have noted how that really bought some extra time for Altria and also improved AT&T's situation before it made the Time Warner deal.

American Water had the opposite situation happen. Its rates had been set based on recovering a cost structure involving a 35% tax rate. When the tax rate fell, the company's fee structure was lowered to give utility customers the benefit of lower taxes too. The company also had to remeasure all its deferred tax items, which become the largest adjustments to EPS:

	2018	2017	2016
GAAP EPS	$3.15	$2.38	$2.62
Gain on Sale	-$0.06		
Impairment	$0.22		
Insurance Settlement	-$0.08	-$0.07	$0.22
Parent Debt Exting.		$0.02	
TCJA Adjustment	$0.07	$0.70	
Total non GAAP adj.	$0.15	$0.65	$0.22
Non GAAP EPS	$3.30	$3.03	$2.84

In addition, the tax cuts are specifically offsetting growth in other areas:

	2018	2017	2016	2015
Rate hikes on New CapX	$149	$81	$92	$45
Acquisitions	$22	$43	$23	$6
Misc/Volume/Adjustments	n/a	-$39	$13	$8
Tax Law Change	-$148	n/a	n/a	n/a
Total Revenue Growth	$26	$87	$128	$69
% Growth	0.9%	3.0%	4.7%	2.6%

Cutting rates to give customers the benefits of the tax rate reduction cut revenue growth to a crawl and that in turn produced lower income and cash flow than would have been expected. Plus, this situation is expected to be a drag on results into 2022.

American Water sees the drag on cash flow from operations as $100 million in 2019, $200 million in 2020, and $100 million in 2021.

The rest of the story is working, the company is getting higher revenues from new investments in the PP&E. It just has a few more years of heavy drag on cash flow at the same time it is making these investments. Right now, this is the most pressure on the growth story and the need for external capital. Over time, this should improve.

AFUDC – Allowance for Funds Used During Construction Is Increasing

This is an accounting treatment used by public utilities to preserve equity in the capital structure. It allows companies to add back the interest costs incurred during construction of new assets that will eventually enter the rate base. The interest expense is still paid in cash. But AFUDC is a non-cash credit that adds it back and inflates income.

Much of the work done by American Water happens fairly quickly and joins the rate base plus interest rates have been lower of late. Both of those situations hold down the size of the AFUDC credit. Despite this, it has been rising and the company is building a desalination plant in California that is expected to be completed in 2021 and is a part of the AFUDC credit.

	2018	2017	2016
AFUDC Borrowed Funds	$13	$8	$6
AFUDC other Funds	$24	$19	$15
Total AFUDC	$37	$27	$21
Adj. EPS	$3.30	$3.03	$2.84
Adj. EPS Growth	8.9%	6.7%	
AFUDC/Share	$0.16	$0.12	$0.08
EPS Growth w/o AFUDC	7.9%	5.4%	

Without AFUDC, the EPS growth rate would be a full point lower.

Non-Regulated Acquisitions Are Getting Larger

American Water has ventured into some new areas in its acquisition strategy. It wants to have some unregulated businesses where it can achieve higher rates of growth. It calls these the Market Based Businesses. The goal is to keep them under 15% of total earnings and remain primarily a roll-out and modernizer of public utility water and waste-water systems.

So far these have come in four areas:
1) Military base water and waste-water systems with the US Government
2) Homeowner warranties for water, sewer, gas lines and appliances
3) Providing water for fracking oil and gas

4) Contract operations to operate and maintain water systems for municipalities and large food/beverage companies

The first problem is the cost is going up and the benefits are not. In 2015, the company spent $133 million to buy Keystone, which provides water for fracking. $91 million of the price was allocated to goodwill. The comment in the 2016 10-K is "*The pro forma impact of our acquisitions was not material to our consolidated results of operations for the years ended December 31, 2016 and 2015.*"

In 2018, American Water bought Pivotal for $365 million to add to its warranty business. Goodwill is $247 million of the purchase price. The company noted it did not have a material impact on results in 2018 and at the time of the deal, it forecast a neutral impact on EPS in 2018 that could become $0.12 in EPS by 2022. That would be about $21 million in additional earnings by 2022. At the time of the deal, the purchase price was said to be 7.5x EBITDA, so EBITDA was close to $50 million. Given a zero impact on EPS and the extra shares issued, we can back into $3.00 in EPS requiring this deal to be producing about $7 million in earnings.

The next problem is how much growth is really here? They only owned Keystone for under three years before encountering problems and decided to narrow the scope of service and exit some of Keystone's prior business. American Water took a $57 million write-down in goodwill or 63% of the total. They also sold the Contract Operations in 2018 as well. This was only for $27 million. The Pivotal unit is expected to quadruple income from $7 million to $28 million in four years.

Market Based Biz	2018	2017	2016	2015
Revenue	$476	$422	$451	$434
Adj Pretax Income	$85	$66	$65	$68

- Adj pretax adds back impairments, subtracts gains

Buying Pivotal added to revenue and income and 2018 has some revenue and income from the Contract Operations prior to being sold. Where is the growth?

While we are often skeptical about warranty/insurance style businesses – we will give American Water some slack in this area. For one thing, the coverage only runs for one-year, which matches the duration of the premium. They are not agreeing to cover damage from water/gas/electricity lines breaking for 5-years after a one-time payment. If they start to see a surge of problems in an area, they can raise premiums or stop renewing warranties in that area.

Also, because the duration of the premium and liability match – this should limit a situation where income is very high in the early years due to a lack of claims followed by falling income as claims increase over time. They also bought an existing book of customers, which should remove some of that front-loading of earnings.

American Water also had a similar business already and had not seen problems with it. There may not be as many growing pains often associated when a company buys something out of its normal experience. We still would question just how much growth potential is here. Many people already carry homeowner's insurance to cover much of the same risk that Pivotal is pitching.

Explanation of EQ Rating Scale

6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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