California Water Service (CWT)

Updated July 12th, 2018 by Aristofanis Papadatos

Key Metrics

Current Price:	$41	**5 Year CAGR Estimate:**	-0.2%	**Volatility Percentile:**	50.2%
Fair Value Price:	$30	**5 Year Growth Estimate:**	4.0%	**Momentum Percentile:**	57.4%
% Fair Value:	136%	**5 Year Valuation Multiple Estimate:**	-6.0%	**Valuation Percentile:**	10.0%
Dividend Yield:	1.8%	**5 Year Price Target**	$37	**Total Return Percentile:**	4.5%

Overview & Current Events

California Water Service is the 3rd largest publicly-owned water utility in the U.S., with a market cap of $2.0 billion. It has six subsidiaries, which provide water to about two million people in California, Washington, New Mexico and Hawaii.

While utilities are characterized by low growth rates, CWT grew its revenues by 9% and its earnings-per-share by 39% last year. The impressive growth mostly resulted from the rate hikes that were approved by the regulatory authorities in 2015. Thanks to this strong performance, the stock has rallied 35% since the end of 2016. This is obviously an extraordinary performance for a utility stock.

However, this year, the regulatory authorities have reduced the return on equity of CWT. In Q1, the company missed the analysts' EPS estimates by a wide margin, as it lost $0.05 per share (vs. an expected profit of $0.05 per share). While the revenue increased 8.4%, the increased cost of water production due to higher purchased volumes and the hikes in wages and benefit costs of employees more than offset the revenue increase.

Moreover, CWT attempted to acquire SJW Group for $68.25 per share in cash but its offer was rejected by SJW Group as unattractive. As the value of the offer was almost equal to the market cap of CWT, the takeover would be very significant if it materialized. However, SJW Group seems determined to merge with Connecticut Water Service.

Finally, CWT is facing the headwind of rising interest rates, which render the dividends of utilities less attractive. Utilities are the most vulnerable stocks to rising interest rates, particularly given their tremendous debt loads. As CWT is just 10% off its all-time high, it is evident that the stock has not been affected by the rising interest rates yet. However, the rising rates will negatively affect the stock at some point. This is a significant risk factor to keep in mind.

Growth on a Per-Share Basis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
EPS	$0.95	$0.98	$0.91	$0.86	$1.02	$1.02	$1.19	$0.94	$1.01	$1.40	***$1.37***	***$1.67***
DPS	$0.59	$0.59	$0.60	$0.62	$0.63	$0.64	$0.65	$0.67	$0.69	$0.72	***$0.75***	***$0.90***

While CWT grew its EPS by 39% last year, investors should not expect similar growth rates in the upcoming years. Just like most utilities, CWT is a typical, slow-growth utility. Due to the disappointing performance of the company in Q1, the analysts have lowered their EPS estimates from $1.42 to $1.37 in the last three months.

Since 2008, CWT has grown its EPS at an average annual rate of 4.4%. The company is likely to continue to grow at a similar rate in the long run thanks to the rate hikes approved by the authorities, as the latter need to continuously encourage the company to keep investing in the expansion and maintenance of its network. In fact, the authorities are forced to determine the optimum rate hikes in order to satisfy both the company and the end consumers, who want limited price hikes but also benefit from the investments of the company. Therefore, it is reasonable to expect CWT to continue to grow its EPS by about 4% per year in the next five years, from $1.37 this year to $1.67 in 2023.

Valuation Analysis

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Now	2023
Avg. P/E	19.8	19.7	20.3	21.3	17.9	20.1	19.7	24.8	29.6	26.9	***29.9***	***22.0***
Avg. Yld.	3.1%	3.1%	3.2%	3.4%	3.5%	3.1%	2.8%	2.9%	2.3%	1.9%	***1.8%***	***2.4%***

CWT looks significantly overvalued at current prices. The utility is trading for around *30 times* expected 2018 earnings. This is absurd for a slow-growth utility. We are giving CWT the benefit of the doubt and estimating a fair P/E of 22, which is around its historical average. If interest rates rise significantly, the P/E could fall much further than 22.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2023
GP/A	15.0%	15.3%	17.5%	17.3%	17.9%	18.3%	17.1%	17.0%	16.1%	15.5%	***15.0%***	***17.0%***
Debt/A	71.6%	72.4%	74.3%	75.7%	76.3%	69.4%	71.4%	71.3%	72.7%	74.7%	***75.0%***	***77.0%***
Int. Cov.	3.4	2.7	2.4	2.3	2.7	2.6	4.1	2.5	2.5	2.9	***3.0***	***3.0***
Payout	62.1%	60.2%	65.9%	72.1%	61.8%	62.7%	54.6%	71.3%	68.3%	51.4%	***54.7%***	***53.9%***
Std. Dev.	46.1%	28.7%	19.8%	25.0%	16.8%	18.9%	22.6%	25.9%	26.8%	21.7%	***25.0%***	***22.0%***

As a typical utility stock, CWT spends tremendous amounts on capital expenses every year and thus carries a high amount of debt. Nevertheless, thanks to its reliable cash flows, it is not likely to have any problem servicing its debt.

In addition, thanks to these reliable cash flows, it is one of the most recession-proof stocks. In the Great Recession, while most companies saw their earnings collapse, CWT grew its EPS by 27% in 2008 and 2% in 2009. Whenever the next recession shows up, CWT is likely to outperform the market once again. In addition, in such an event, the interest rates are likely to fall and will thus help mitigate the contraction of its P/E ratio.

Final Thoughts & Recommendation

Due to its 35% rally since the end of 2016, CWT has reached highly overvalued levels. Despite its 10% correction this year, the stock still has a markedly rich valuation. Consequently, the stock is likely to offer a -0.2% average annual return in the next five years, thanks to its 4% average annual EPS growth and its 1.8% dividend yield, which will be more than offset by a 6.0% average annual contraction of its P/E ratio.

As CWT is a slow-growth utility stock, investors should be particularly careful before initiating a position. If you overpay for a slow-growth stock, it may take several years to *break even*. Therefore, investors should wait for a much better entry point. Even extremely conservative retirees should stay away from the stock, as its rich valuation has resulted in a lackluster 1.8% dividend yield.

Total Return Breakdown by Year