



California Water Service (CWT)

Updated July 27th, 2018 by Nick McCullum

Key Metrics

Current Price: \$41	5 Year CAGR Estimate: -0.3%	Volatility Percentile: 50.1%
Fair Value Price: \$30	5 Year Growth Estimate: 4.0%	Momentum Percentile: 52.1%
% Fair Value: 136%	5 Year Valuation Multiple Estimate: -6.1%	Valuation Percentile: 9.3%
Dividend Yield: 1.8%	5 Year Price Target: \$37	Total Return Percentile: 4.2%

Overview & Current Events

California Water Service is the 3rd largest publicly-owned water utility in the U.S., with a market capitalization of \$1.9 billion. It has six subsidiaries, which provide water to about two million people in California, Washington, New Mexico and Hawaii. California Water Service was founded in 1926 and has increased its dividend for 51 consecutive years, making the company a Dividend King.

In late July, California Water Service reported (7/26/18) financial results for the second quarter of fiscal 2018. In the quarter, total revenue of \$172.6 million increase by 0.9% over the prior year's period. Net income of \$13.0 million declined significantly from the \$18.5 million reported in the prior year's period. The company provided the following explanation on this decline in earnings: *"The \$5.5 million decrease in net income was driven primarily by \$3.6 million of new business development expenses, a reduction in operating revenue of \$1.7 million due to the cost of capital decision for California Water Service (Cal Water), \$1.7 million in additional depreciation and amortization costs, \$1.2 million in additional wage costs, a \$0.7 million increase in maintenance expense, and \$1.3 million in additional interest expenses all of which were partially offset by rate increases of \$4.5 million."* Clearly, a number of complex factors contributed to the year-on-year decline in net income. California Water Service's financial performance disappointed the financial markets and shares fell slightly following the announcement.

Previously, California Water Service announced (7/20/18) that it is extending the expiration date of its \$68.25/share tender offer for SJW Group to September 28th, from August 3rd previously. The acquiring company said in a press release that it continues to believe its tender offer *"provides far greater value to SJW stockholders and is therefore significantly superior to the highly conditioned proposed merger"* from Connecticut Water Service (CTWS).

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

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. These estimates are unchanged from the time of our last quarterly research report.

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	30.1	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%

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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.

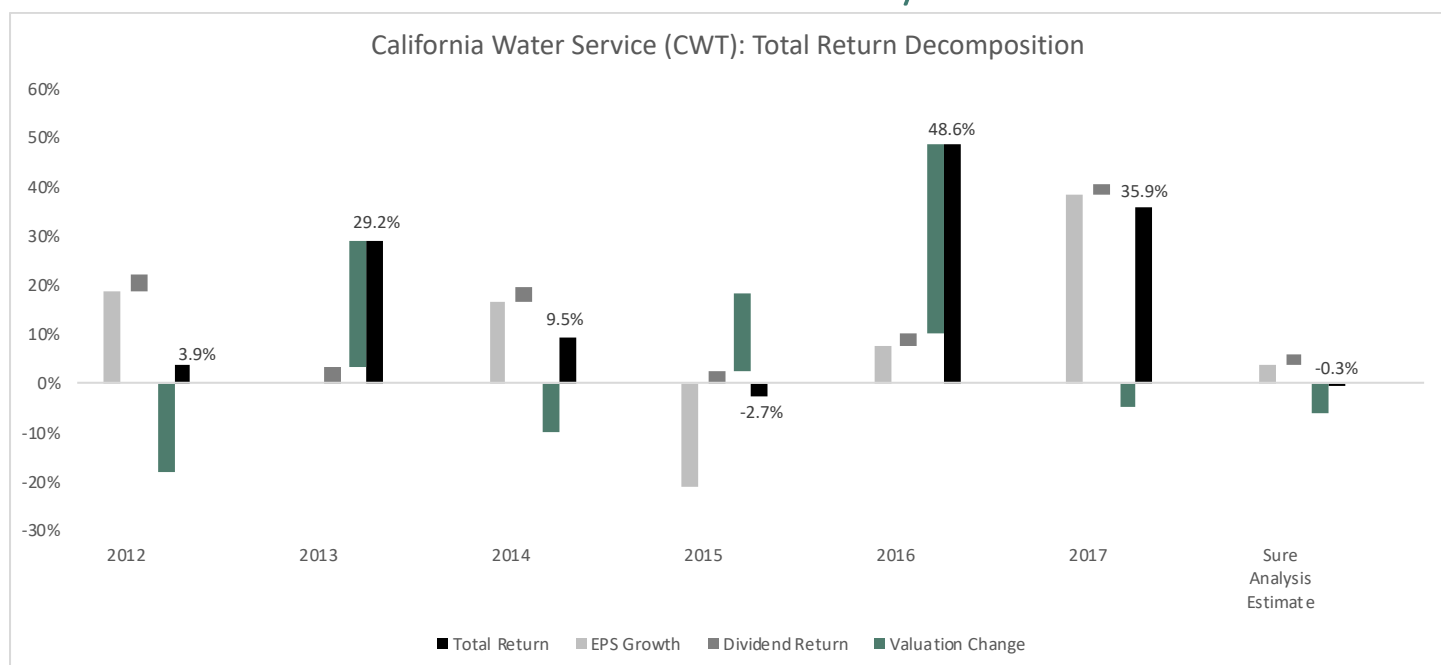
In addition, thanks to these reliable cash flows, California Water Service is very recession-proof. In the Great Recession, while most companies saw their earnings collapse, CWT grew its EPS by 27% in 2008 and 2% in 2009. Whenever the next recession occurs, CWT is likely to outperform the market once 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 a tremendous rally in its stock price, CWT has reached highly overvalued levels. The stock is likely to deliver flat or negative returns over the next five years, thanks to its 4% average annual EPS growth and its 1.8% dividend yield, which should be more than offset by significant contraction in its valuation multiple. California Water Service's lackluster growth prospects combined with its poor total return profile earns it a strong sell recommendation from Sure Dividend.

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



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