Sand Spring Advisors LLC

Back to Water

by,

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Back in our October 2004 article *Dark Cloud Cover & Places to Hide*, we spent a considerable amount of time discussing the water industry as an interesting investment opportunity both over the short and long term. At that time, we put forward three chart patterns that we were particularly bullish on: Consolidated Water Company (CWCO), then trading at just under $24; Cuno Incorporated (CUNO) then trading at $55; and California Water Service (CWT) then trading just above $29.

Today, Consolidated Water has advanced 50% to near $36 (where we recently took profits). Cuno International just received a takeover bid at $72 -- a 31% advance from our October suggestion. And California Water has moved up 24% to $36. This is not a bad result considering the broader indices have advanced by only about 8% since that article's publication.

So we thought it might be fun (and potentially profitable for our readers) to highlight the chart patterns of some other water stocks that we also recently became involved with as long positions.

Our first and favorite is Calgon Carbon (symbol CCC) pictured below. This company is a major carbon filtration company that also has become involved with UV filtration systems for municipal drinking and wastewater facilities around the world. In addition, CCC also provides air filtration devices that can prevent any toxic gases from being sucked into government and other office buildings – thereby making the company a homeland security play as well. The company took on some debt to make an acquisition at the end of 2003, but this acquisition has been accretive, and the company has already make a good start at paying down the extra debt burden. The company has simultaneously worked to cut costs across its various business lines. Calgon Carbon recently made a push into the Asian markets, and we believe that the company is well positioned to benefit from the water filtration opportunities that are abundant in that region. Although we must admit that this stock trades at a healthy multiple to its 2004 earnings (59x), we also like the chart pattern quite a bit as shown below. If one were ever given the opportunity to buy this stock near its $7.04 Fibonacci support, we would view such as a golden opportunity. On the upside, we see an initial zone of resistance near $10.04 and then up at $11.92 – levels where it might be prudent to temporarily trim involvement.

What exactly is the water situation in China? At the tail end of this article, we have attached a short piece on this topic by John Dickerson of Summit Global Management, Inc – a specialist water industry investment manager for accredited investors based in La Jolla, California. Reading Mr. Dickerson's article, the long term picture is clear. China is going to have to spend a great deal of money on water filtration and purification. The only thing in doubt is which companies will be part of this process. We think Calgon Carbon has a shot to be one.

Another interesting water filtration company is Massachusetts-based Millipore Corporation (symbol MIL). This company manufactures everything from small bench top laboratory water purification systems and cartridge integrity testers to large stainless steel process scale filtration and chromatography systems. Their systems are critical in the exploration and testing for new therapeutic drugs, and the company already has a presence in the Asian region. At a somewhat less lofty 24x P/E when compared to Calgon Carbon, we see the chart of Millipore poised to advance smartly – first towards a $81.87 initial target and maybe someday towards a second fractal target up at $121.51.

Another company involved with sophisticated water filtration for business and industry globally is Sunnyvale California-based Dionex Corporation (symbol DNEX). They design, manufacture, market and service liquid chromatography systems, sample preparation devices and related products. The products include ion chromatography, high-performance liquid chromatography and accelerated solvent extract systems, Chromeleon chromatography software and consumables. These products are used in environmental analysis, life science, biotechnology, chemical, petrochemical, power generation, food and beverage and electronics industries.

The stock is a somewhat volatile one, but we like its longer-term Fibonacci rhythm that appears pointed towards an upside target just above $79.

Elsewhere, within the water irrigation equipment industry, we see Lindsay Manufacturing (symbol LNN) to be a longer-term winner. Lindsay's principal activity is to design and manufacture self-propelled center pivot and lateral move irrigation systems. In addition to its U.S. presence under various brand-names, it has operations in Latin America, Africa, and Europe. The company has been exporting units to China for years, and recently began limited production there through a subcontract agreement. Building a full distribution network in China is on the company's future agenda. And as China modernizes at the same time that its water table is slowly dropping, just think of the demand potential that will exist for water irrigation equipment.

Lindsay has recently been buffeted by higher steel costs per irrigation unit produced and an unfortunate earnings miss partly attributed to Sarbanes-Oxley related legal costs, but it has a very strong balance sheet, and we like the look of its Fibonacci rhythm for an eventual upside target of $35.15.

And then we come to Layne Christenson (symbol LAYN) – a historically poorly managed company active in the water, mineral, and energy drilling industry. Layne is currently under pressure from a variety of New York activist hedge funds (including a group called Steel Partners) to unlock better value for its shareholders by streamlining its business model. Like Lindsay, this company also recently missed its earnings target because of added legal costs related to Sarbanes-Oxley compliance, but longer-term we see quite a bit of potential upside here. $13.76 Fibonacci support would be an ideal buying region (if offered by the market), while an upside Fibonacci target of $31.16 beckons over time.

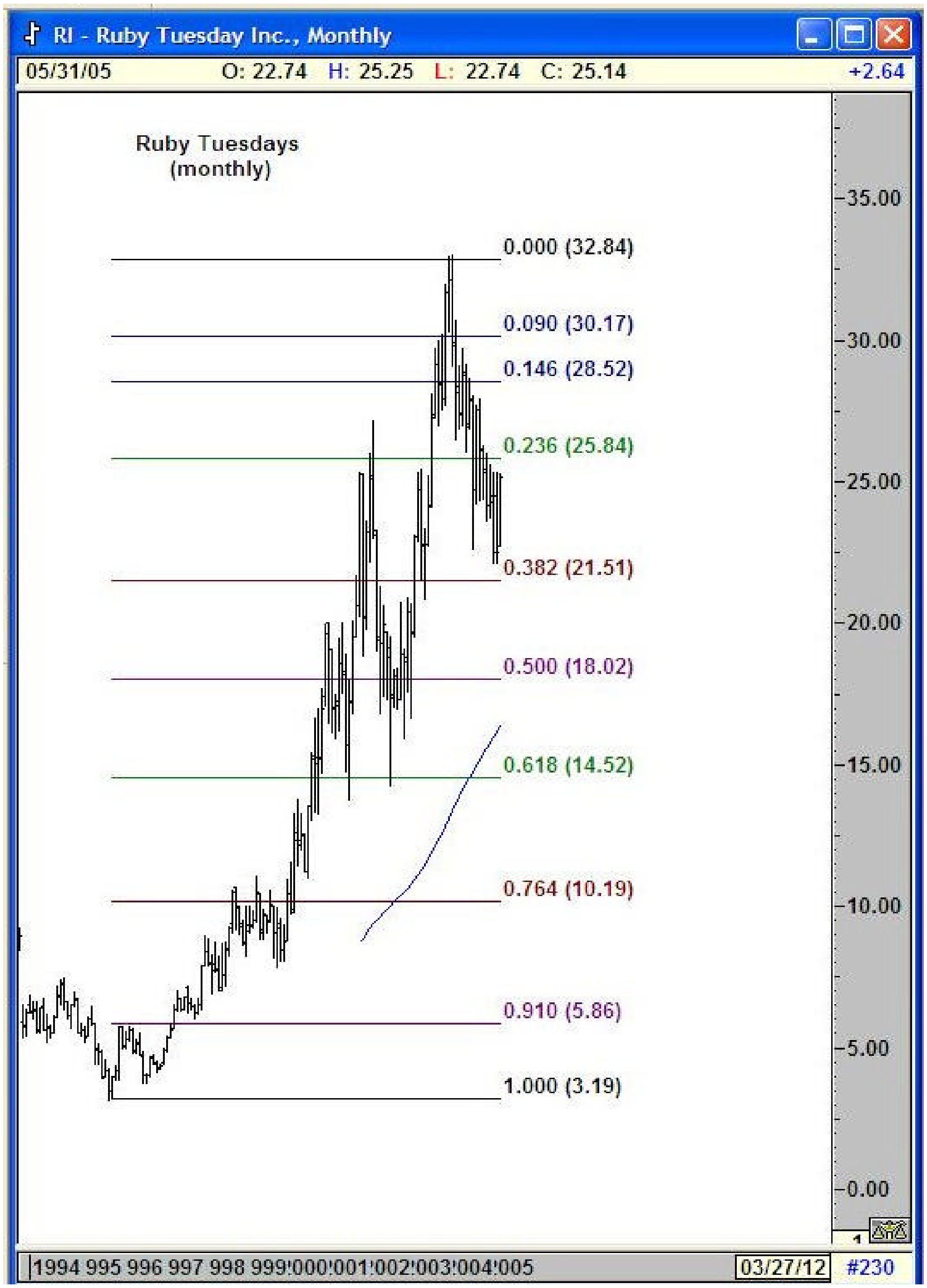
Lastly, on the long side of our water industry suggestions (albeit not China-related), let us throw in one chart of a U.S. utility that still appears positively disposed to our Fibonacci eye: SJW Corp. This stock currently trades near $41, while sporting a rhythm that suggests $49.93 should eventually be seen. SJW produces, purchases, stores, purifies, distributes and sells water to customers in portions of the cities of Cupertino, San Jose, Campbell, Monte Sereno, Saratoga, Los Gatos, and Santa Clara, California. Priced at 18x earnings as a service provider to municipal utilities, SJW is not exactly a cheap stock, but it does throw off a 2.5% annual dividend, and appears poised for further stock appreciation.

There are surely some other opportunities in the water industry, but the above are the ones that currently have caught our technical attention due in part to their Fibonacci rhythms. In the case of several (all actually except CCC and SJW) we are also trying to highlight good longer-term stocks, but ones that have recently experienced a trading set-back and thereby may offer a reasonable buying opportunity.

A Few Miscellaneous Thoughts on the Dark Side

But before we get criticized for putting out a letter with long-only suggestions – something that would be highly unusual for the typically bearish and dour Sand Spring Advisors -- we will leave the water industry at present to suggest a few potential short ideas in other areas.

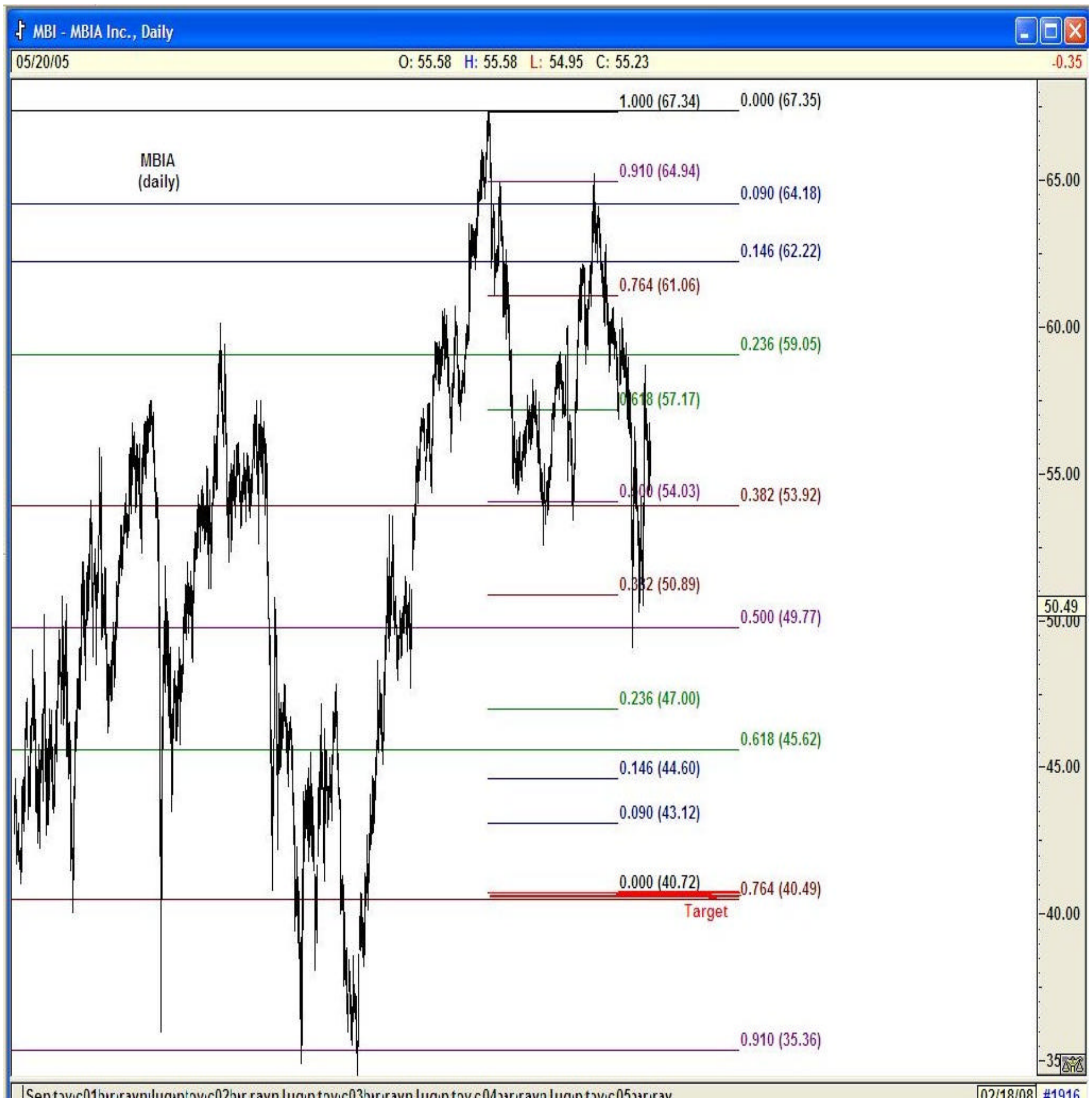
One of our favorite potential shorts over an intermediate time frame is Ruby Tuesday's (symbol RI) -- a slightly aging middle-market restaurant chain, with upward food and labor cost pressures and yet foot traffic growth that appears to be slowing. The company recently missed targets on its latest earnings release, and as the U.S. consumer is finally forced to slow down credit card spending over the balance of 2005, Ruby Tuesday's should be first in the line of fire to see its revenue base fall. If we were to see a summertime bounce back toward $28.50, such an event could be a great opportunity to establish or add to short exposure here.



As a second idea, with a flattening yield curve, it also cannot be that long until a company called Allied Capital (symbol ALD) falls from grace. This company pays of a huge dividend largely derived from leveraged mezzanine lending investments (that are typically financed at the front end of the yield curve). The company has also historically invested in REITs, Collateralized Mortgage-backed Securities (CMBS), and collateralized debt obligations (CDOs), but recently admitted in May to selling the CMBS and CDO portions of this portfolio. ALD also has entered into an agreement to sell portions of its real estate holdings. Did management suddenly feel squeezed between falling asset prices (from widening credit spreads) and a large promised ALD dividend payment? How will management be able to re-create the revenue that these prior investments threw off in the past?

In our mind, this company still remains highly exposed to all the excesses of the current financial debt/leverage mania, and is simply starting to show previously hidden warts. Many believe that Allied Capital could be a huge Ponzi scheme destined to fall from grace. The faster that the yield curve flattens and credit spreads widen, the faster that we will find out. Allied Capital badly missed its earnings target in the 4th quarter of 2004 (although no one seemed to really care that much at the time), and subsequently made a rushed announcement of its first quarter 2005 results at the same time that management also announced its CMBS/CDO fire sale. We smell problems in the portfolio that may have made this shift "required" as opposed to "voluntary." The Fibonacci price rhythm between this company's 1996 low and 2004 high looks "complete," and thereby bearish for a larger move lower. From a timing basis, we are not sure when ALD may break, but be ready.

And as a last “repeat” suggestion on the short side – MBIA (symbol MBI) appears to have started its step and stumble lower toward a previously espoused target near $40.72.



We are also still negatively disposed to companies such as XL Capital (symbol XL); MGIC Investments Corp (symbol MTG); Ambac Financial (symbol ABK); and Washingtom Mutual (symbol WM). All sport complete-looking Fibonacci rhythms starting to roll lower. All are highly leveraged players in the world of finance that stand exposed to higher short-term interest rates and a flattening yield curve.

So overall -- if one wants to play the part of a sector-thematic hedge fund manager: buy the water industry and sell the financial industry. Then go enjoy the summer and play some golf. Both the charts and the fundamentals should be working for you as you do.

John Dickerson’s comments on the water situation in China follow our Disclaimer page. We thank him for his permission to include this material for Sandspring.com readers.

Send us your comments at information@Sandspring.com.

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Startling Facts Emerge from China's Water Crisis

April, 2005

For months we have been delving into the investment opportunities created by the water crisis in China, and we are finding that the more we dig the more we uncover startling facts about the nature and extent of this massive problem confronting China. Indeed, we now believe that the severity of water-related problems in China is much worse than we had thought just a couple of months ago, and thusly, our opinion on the related investment opportunities has also intensified.

The water problems in China begin with natural scarcity, intensified by persistent drought in recent years. More importantly, China's scarce water is not evenly distributed, and this is the source of major problems. Taken as a whole, China starts with total water resource volume per capita that is only 25% of the global average, and per capita water volume in Northern China is only 10% of the world average.

The water distribution problem is exacerbated by the fact that the North has only 19% of the water in China yet this area contains 47% of the population, produces 45% of the GDP, and contains 65% of the cultivated land in the country. This mismatch between water resources and use has created a substantial obstacle to the sustainability of China's economic growth, which in turn has been 30% of world GDP growth in recent years. The water problems in China could become a negative influence beyond China's borders if the situation is not improved.

World wide, per capita water availability is some 16 times greater than it is in China's most water scarce areas, and yet these parched areas in the northern part of the country are home to nearly 8% of the total world population. Moreover, water supplies for these people are going down, not up. According to accepted world standards of water scarcity, the water supply in all of North China is now at just ¾ of the recognized danger level, and in the North China Plain area the annual water supply is now at a crisis level of only ½ of the minimum world standard to sustain public health and safety.

With just half a percent of the world's fresh water, the economic output of the North China Plain is equal to almost all of South America (excluding oil-rich Venezuela) and is larger that the combined GDPs of India and Pakistan. The Plain is quite large in land area, but more importantly, contains a population larger than that of the European Union. Here's why the crisis in the North China Plain is so critical: Some 75% of the water in this critical area which produces 45% of the GDP comes from non-renewable groundwater, in other words, from water wells. As these wells are depleted, the threat to a sustainable economic system in the area multiplies, and the reverberations of any such events could have global implications.

The natural scarcity of water in China is one thing, but quite another is the amazing lack of any governmental efforts, until quite recently, to do anything about the water problems. It seems that, in their quest for growth at all costs, the costs in water terms will soon begin to mitigate, if not stop, the growth. Consider the conditions below, which have been allowed to advance even in the face of the obviously critical lack of fresh water supplies.

While consuming the water supply at a profligate and non-sustainable pace, China has done little to extend the use of the tight supply by processing water before consumption, or recycling water after it has been used. As a result, about 700 million people, over half of China's population, are now forced to consume raw water that has been minimally processed or not processed in any way. This water is well below World Health Organization standards and is dangerously contaminated by industrial pollution as well a human and animal waste, causing the widespread health problems that have become a huge economic burden.

At the end of 2003, only 310 of the 669 larger cities in China had constructed even a limited version of municipal wastewater treatment facilities. In the 17,000 smaller towns spread across China, most have no wastewater treatment capability, and the waste is simply discharged into surface water bodies without any

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treatment at all. Is it any wonder that China is experiencing severe water pollution problems in the already critically short supply and this is leading to pervasive water-borne and water-related health problems in the general populace? This populace, of course, is the source of the cheap labor which is the primary economic engine of China, and any harm to this labor force therefore has profound economic implications.

Shockingly, about 30% of the monitored river water in China now ranks worse than the minimum safety standards accepted globally, meaning that this water is not suitable even for the lowest agricultural or industrial uses. Moreover, more than 75% of China's urban drinking water is considered unsuitable for drinking or cooking, and some 80% of China's seven major river systems no longer support fish.

China has been a production marvel when it comes to labor costs, but when it comes to water costs it is an abject failure. Because of low labor costs, China now produces 30% of the world's total annual economic growth, and thus far the labor advantage has overwhelmed the limiting factor of water scarcity, but those two lines may soon begin to intersect. Consider this: To produce a unit of GDP, China uses approximately 7-15 times more water than do developed countries, and with usable water supplies steadily diminishing, will not their competitive position also begin to erode?

After ignoring their critical water and environmental problems for way too long, government at all levels in China is finally beginning to attack these problems out of forced necessity. Water problems have now become the first priority of the government, because of rampant health and absentee problems in the work force, factory shut-downs from lack of water, and grain imports becoming necessary for the first time because of depleted ground water in agricultural areas. Moreover, much-needed construction of electrical generation plants are being postponed in some areas because of lack of water for the boilers and for dissipation of heat, and these critical power plants are necessary to sustain economic growth.

All around the world, every investment planning or strategy session probably includes the word "China" very early in the discussion. Essentially, the world outside China has been asking itself, "what are we going to sell to China, and how can I benefit in this process?"

This logic seems to make sense from the outside looking in, but how do things look from Chinese eyes looking at what China needs most? China now realizes that what it needs most is a dependable and safe internal water supply and a clean environment to act as a stable platform for sustainable economic growth; growth not sustainable under current conditions. To our way of thinking, that is the most basic and predictable "China Play".

China must depend on outside companies to provide the products and technical expertise to help solve China's critical water and environmental problems, and these companies are looking at strong demand from China for years to come. We have identified a list of international companies with growing revenues from significant involvement in the water and related problems within China, and when these equities can be purchased in line with our value investing criteria, these stocks will become core holdings within our global water investing strategy.

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