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Bull market archetype

Evan Lorenz writes:

The S&P 500 leapt by 31.5% last year not because of corporate profits but in spite of them, and if Wall Street forecasts are on the beam, earnings per share will register a fourth consecutive quarterly decline in October-December. Yet hope springs eternal, and the undaunted analysts project a 9.7% rise in EPS for the blue-chip index in 2020.

As for what might happen if results fall short, we turn to Badger Meter, Inc. (BMI on the Big Board), a kind of avatar of the average 2019 supercharged equity. Slightly outlegging the S&P, Badger last year generated a 33.4% return that profits alone can't explain: Badger's earnings per share slipped by 4.3% in the third quarter after adjustments for a one-time pension expense. And in Badger's case, too, the future is painted brighter than the immediate past, with Wall Street predicting a 7.1% EPS rebound in 2020. In preview, we're bearish on the meter maker and wary on what its valuation and vulnerability may signify for the stock market as a whole.

In 1905, a pair of German immigrants, Albert E. Gumz and Alber W. Wingender, cracked a problem bedeviling their new hometown of Milwaukee: How to measure water flow in the freezing Wisconsin winters? Thus was born the "frost-proof" water meter and the Badger Meter Manufacturing Co.

Still in Milwaukee and with 84% of current revenues relating either to measuring or controlling the flow of water, BMI has stayed close to its roots. Sales of water meters, radio endpoints and software to utilities generate 76% of the top line. The balance consists of valves

and meters used in water-related industries (8% of sales) and non-water uses (air, steam, oil and other liquids; 16% of sales). While Badger does a worldwide business, domestic sales account for 86% of third-quarter revenues.

A "comfortable" oligopoly is how the bulls describe the water-meter industry, with Badger, Roper Technologies, Inc. and Xylem, Inc. each commanding about 30% of the market, according to estimates by Tate Sullivan, who rates BMI a buy for Maxim Group, LLC. In such a stable structure, the level of competitive pressure is profitably low.

The bull story continues with a technology-driven upgrade cycle. Not much changed in meter technology in the century or so after Gumz and Wingender brought forth the frost-proof. American utilities employed workers to check mechanical meters every 30 to 90 days. The devices used (and continue to use) the flow of water to move a piston or disk inside the meter. Labor costs are high, and the meters lose accuracy as their parts wear down.

But frost-proof never meant disruption-proof. Utilities today are attaching radios to meters, or buying new radio-equipped ones, to save the cost of human meter readers. Some are starting to install a new kind of meter that, with no moving parts, calculates flow by measuring the sound of water traveling through the pipes.

The radio systems of the 1990s still required drive-bys to collect a meter's beaming signals, but newer systems send data directly to the utility's command center. According to IHS Research, radio-equipped water meters, as a percentage of the American installed-meter

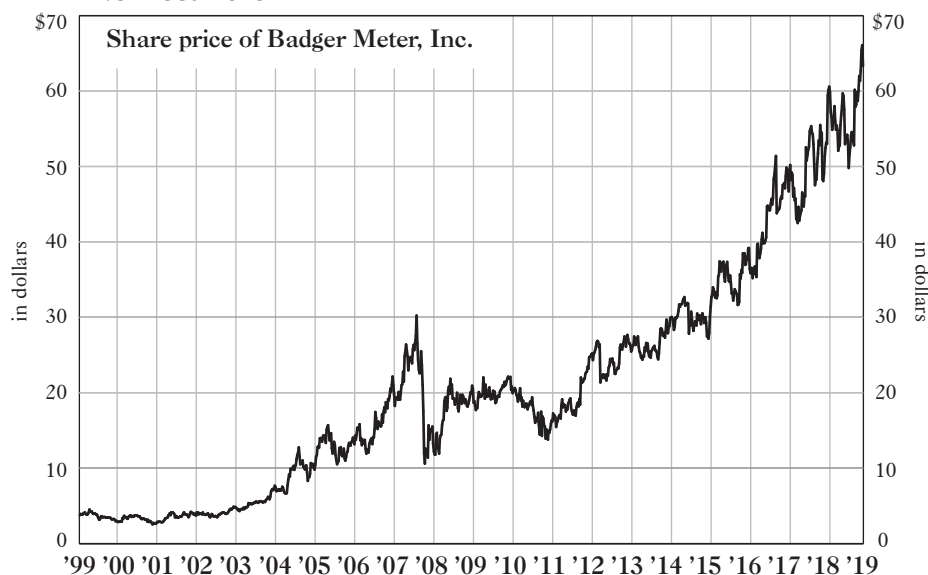
base, have jumped to 65% from 40% in 2013, though it's not because they're cheaper: A radio-equipped mechanical meter sells for up to \$150–\$250 compared with \$40–\$50 for the legacy kind.

Additional innovations may extend the upgrade cycle. The aforementioned nonmechanical meters, lacking moving parts, boast improvements in durability and accuracy. More sensitive than the older ones, they can pick up the drip-drip-drips that legacy instruments miss. Utilities are pleased with the resulting pickup in revenue—and the meter manufacturers with the higher list prices that the nonmechanical meters command. In Badger's case, the pickup runs to around 100%.

On the July 18 earnings call, Badger CEO Kenneth Bockhorst said that mechanical meters contributed 85% of sales by units. Bullish dialers-in were left to contemplate the possibilities of customer migration to the newer, costlier products, skeptics to ponder what might happen if Badger misplays the upgrade cycle. Badger, too, sells a cloud-based software suite under the brand name "Beacon" that allows utilities and their customers to monitor water usage, water quality and leaks. As of the third quarter, Beacon accounted for around 3% of total sales, on its way—so Bockhorst projects—to 10% over the next five years.

The value proposition for the buyer of nonmechanical meters is a bump up in revenue of 10% or more over the lifetime of the device. Joel Carty, president of Diameter Services, a firm that consults utilities in the design, procurement and management of meters, tells me that such gains, documented though they are, nonetheless strike some old hands as im-

No frost here



source: The Bloomberg

plausibly high.

"We've done a few bids where we wanted to compare a mechanical meter to an ultrasonic meter," he says. "When I did that, the savings generated from nonmechanical meters that I came up with was so large that the mechanical manufacturers probably wouldn't bid the mechanical. We've had to dial back the potential benefits in order to make sure we are getting bids from all types of technologies."

Based on such drivers, said Bockhorst on the Oct. 17 earnings call, Badger forecasts sales growth in the American utility market of between 6.5% and 8.5% "for the long cycle." It's this multi-year projected tailwind that, to bulls, makes BMI a compelling investment. "When you have a technology-adoption cycle taking place in a 100-year-old industrial market," Sullivan tells me, "that can lead to higher margins and ongoing new peaks in EPS."

The positive story rounds out with a squeaky clean balance sheet (net cash of \$33.4 million as of Sept. 30) and the fact that Badger has raised its dividend every year for the past 27 years.

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Then, again, it can't be said that the market has overlooked the good news. Badger's stock trades at 39.7 times trailing earnings, 20.8 times enterprise value to Ebitda and, at these lofty prices, delivers a 1.1% dividend yield. Of the six analysts who rate the company, one says buy, another says sell and four say hold.

Not that every Badger shareholder is paying attention to price, value, funda-

mentals or other such old-time ephemera; BlackRock, Inc., The Vanguard Group, Inc. and State Street Corp.—the passive investing giants—own 15.2%, 11.5% and 3.1% of shares outstanding, respectively. Within this indexed world, BMI wears many nomenclatural and factorial hats. It's a constituent member, for instance, of the iShares Core Dividend Growth ETF, the SPDR S&P 1500 Momentum Tilt ETF and the SPDR S&P 1500 Value Tilt ETF, among others. Just how a price-to-earnings ratio of 39.7 accounts for the insignia of "value," even in 2020, is a puzzle we leave to some future congressional investigating committee.

Not waiting, doubters have built up a short interest equal to 9.5% of the BMI float. On Jan. 2, Chip Moore, analyst at Canaccord Genuity, LLC, downgraded the stock to "sell" from "hold," though not

because of any fundamental weakness: "We expect Badger Meter to maintain its strong competitive positioning overall . . . even as we find competitive pressures to be increasing here (a trend we find likely to continue in the years to come)," said he. Moore's concern lay rather in the risk inherent in elevated valuations.

They are, in fact, extreme, especially in the light of recent meter-related acquisitions—for example, Honeywell International, Inc.'s purchase of Elster Group S.E. (2015), Xylem's takeover of Sensus USA, Inc. (2016) and Hubbell, Inc.'s buy of Aclara Technologies, LLC (2018). The transactions took place at an average of 11.8 times Ebitda, just slightly more than half of Badger's current multiple.

Nor does recent trend growth in the corporate top line instill confidence. Despite the technology-driven upgrade cycle, Badger's sales showed year-over-year declines of 1.8% in the third quarter and 3.7% in the nine months through September. On the Oct. 17 call, management blamed a large order from the Middle East in 2018 for creating tough year-over-year comparisons. Anyway, despite many acquisitions, Badger's revenues have compounded at an anemic 4.7% rate in the three years ended 2018. (As to the contribution of such accessions to sales growth, management customarily says little.)

In contrast, the other U.S. water-meter oligopolists appear to be making hay. Third-quarter orders at Roper's Neptune division outstripped the company's ability to produce, said Roper management, which, it pledged, is "working aggressively to boost production." In the same period, year-over-year revenue at Xylem's American water-related Sensus business bounded higher by 9%.

Badger Meter, Inc. at a glance in \$ mns except per share data

	2014	2015	2016	2017	2018	TTM*
revenue	\$364.8	\$377.7	\$393.8	\$402.4	\$433.7	\$421.5
operating income	44.9	41.2	49.8	55.6	35.9	39.6
net income	29.7	25.9	32.3	34.6	27.8	46.1
EPS	1.03	0.90	1.11	1.19	0.95	1.57
shares outstanding (mns)	28.9	29.1	29.1	29.1	29.1	29.2
debt	75.9	71.4	38.0	44.6	18.1	4.4
cash	6.7	8.2	7.3	11.2	13.1	37.7
total assets	341.2	355.5	349.7	391.7	392.7	417.5

* For the period ended Sept. 30, 2019.
source: company reports

Clearly, competition is hotting up. While Europe may lack a Silicon Valley, it long ago took the lead in nonmechanical water meters. The belated adaptation of that improvement in America therefore opens the door to a formidable assortment of experienced European vendors. They previously faced a dilemma. To compete in America during the prolonged mechanical phase of the meter market, they would have had to revert to producing mechanical devices. This, they were no readier to do than Lockheed Martin Corp. would have been to resume production of the vintage P-38 Lightning.

Not until 2018 did the American Water Works Association, the standard-setter for water meters in the United States, approve new guidelines for meters without moving parts, almost 20 years after that technology took off across the Atlantic.

"Badger was protected for a long period of time from their ties to the standard-setting body, which perpetuated a mechanical standard that was clearly behind the times from the standpoint of the silicon-based stuff," a short-seller tells me (he asks to go nameless). Our source observes that former AWWA standard-setters have found jobs at Badger and the other domestic oligopolists, a fact that perhaps incentivized the industry, manufacturers and standard-setters alike to hew to the tried and true.

Now such European makers as Kamstrup, Diehl Stiftung GmbH & Co. KG and Itron, Inc. are migrating to America. While Kamstrup opened a new water-meter factory in Georgia last year, Itron poses a bigger threat to the once comfortable Americans. A longstanding presence in this country, Itron, alongside Roper's Neptune, is one of the two top providers of radio antennas for water meters—in fact, according to Moore, Itron supplies

antennas to some Badger meters. Itron says it's mobilizing its sales force, already familiar to America's 52,000 water utilities, to push its ultrasonic Intelis water meters in addition to the customary radio antennas and software-management tools. Itron first introduced a North American version of the Intelis meter at an AWWA conference in 2018. For a sense of scale, during the third quarter, Itron's sales in the United States and Canada alone were 3.7 times Badger's sales worldwide.

Both Badger and Itron manufacture and sell radio transmitters that use cellular signals and transmitters that work on proprietary radio networks. Suffice it to say that each technology has pluses and minuses. Badger's focus is on cellular networks, Itron's on closed networks.

Last year, Badger judged that two customer accessions were important enough to announce in a press release: They were the water utilities of Columbia, S.C., with just under 150,000 customers, and Aurora, Col., with all of 87,000. Neither city went for high-margin ultrasonic meters, rather settling for the budget, mechanical kind.

Itron seems to set a rather higher standard for press-release promotion. Thus, on Dec. 3, management trumpeted the news that it will replace 280,000 antennas (out of more than one million) of the Louisville Water Company and that that utility has agreed to install Itron's water-meter software.

While a cellular system is quick to establish, it likewise entails higher operating costs in the form of a monthly AT&T bill. Such ongoing costs are what have pushed many utilities to adopt closed networks, i.e., Itron's kind, Carty tells me: "There have been improvements and price reductions in the ongoing costs of a cellular system, but they are still sig-

nificant." Then, too, past investments also push utilities away from cellular networks. As mentioned, 65% of water meters have a radio antenna. Because stand-alone radio networks are proprietary, switching to cellular means replacing all the antennas already attached to meters.

A bet on the wrong communications strategy would make it harder for Badger to meet its five-year target for ramping up the sales of Beacon to the point at which that software suite generates 10% of the overall top line. However, regardless of whether Badger nails its communications strategy, the company faces more competitors at every customer request-for-proposal today than it did just three years ago.

As for what this means for the stock, we turn again to our anonymous bear. He observes that about 7 out of every 10 Badger shares are in the hands of non-indexed investors. "Your risk manager forces you to hug the benchmark, because otherwise you're dead, so you need to know 500 names—500 names," our source says. "Most people don't know 50 names. So as long as BMI ticks the box when they report earnings, no matter how much this is contradicted by accounting, etc., the portfolio manager says, 'We're O.K. here,' and moves on. It is only when they miss does the PM say, 'Sell it—we were duped. . . . It's O.K.—it is the way of the world.'"

Management itself seems doubtful, at least when it comes to their own money. Over the past 12 months, insiders have sold 70,036 shares for proceeds of \$4 million. Some are voting with their careers. On Jan. 1, 2019, Richard Meeusen and Richard Johnson, the former CEO and CFO of Badger, retired. On Jan. 1, 2020, Meeusen relinquished his role as chairman, too.

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