Q4 2022 Earnings Call

Company Participants

- Cheryl D. Norton, Executive Vice President and Chief Operating Officer
- John C. Griffith, Executive Vice President and Chief Financial Officer
- M. Susan Hardwick, President, Chief Executive Officer and Director
- Maureen Duffy, Senior Vice President, Communications and External Affairs

Other Participants

- Gregg Orrill, UBS
- Richard Sunderland, J.P. Morgan

Presentation

Operator

Good morning, and welcome to American Water's Fourth Quarter and Year-End 2022 Earnings Conference Call. As a reminder, this call is being recorded and is also being webcast, with an accompanying slide presentation, through the company's Investor Relations website. The audio webcast archive will be available for one year on American Water's Investor Relations website.

I would now like to introduce your host for today's call, Maureen Duffy, Senior Vice President of Communications. Ms.Duffy, you may begin.

Maureen Duffy {BIO 16557243 <GO>}

Thank you. Good morning, everyone, and thank you for joining us for today's call. I'm filling in today for Aaron, who is a bit under the weather. At the end of our prepared remarks, we will open the call for your questions.

Let me first go over some safe harbor language. Today, we will be making forward-looking statements that represent our expectations regarding our future performance or other future events. These statements are predictions based on our current expectations, estimates and assumptions. However, since these statements deal with future events, they are subject to numerous known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from the results indicated or implied by such statements.

Additional information regarding these risks, uncertainties and factors as well as a more detailed analysis of our financials and other important information is provided in the fourth quarter earnings release and in our 2022 Form 10-K, each filed yesterday with the SEC. And finally, all statements during this presentation related to earnings and earnings per share refer to diluted earnings and earnings per share.

Susan Hardwick, our President and CEO, will comment on our successful 2022 and our longer-term performance expectations and shareholder value. John Griffith, our Executive Vice President and CFO, will cover our 2022 financial results in more detail, provide an update on acquisition activity and will close with a review of our outlook for 2023 and beyond, including financing plans. Cheryl Norton, our Executive Vice President and COO, will then discuss our capital investment plan, rate base growth expectations and active general rate cases before concluding with some ESG recognition we recently received. We will then close by answering your questions.

With that, I'll turn the call over to American Water's President and CEO, Susan Hardwick.

M. Susan Hardwick {BIO 16618718 <GO>}

Thanks, Maureen, and good morning, everyone. Thanks for joining us today. As we announced yesterday, we finished 2022 with strong financial results that were just ahead of our plan. As shown on Slide 5, earnings were $4.51 per share for the year, which included $0.06 per share of favorable weather we had previously discussed. Excluding weather, earnings of $4.45 per share were just above the midpoint of the guidance range we shared originally back in November of 2021.

Think about what has occurred globally since November of 2021, including widespread inflation, interest rates on a significant climb upward, Russia's invasion of Ukraine, and many people returning to the office as the world began to stabilize following recurring waves of COVID outbreak. When I reflect on how much has changed in the world since November of 2021, I'm very proud of our company's ability to stay focused on serving our customers safely and reliably, which gave us the ability to confidently execute on the plan we shared 1.5 years ago.

I'm also proud of the resilient service we consistently deliver, and especially over the last few months during an active and better cold storm season across the country. I want to thank our employees for safely providing reliable service to the 14 million people we serve in their homes, businesses and communities.

You can see here on Slide 5 a checklist of some of our key accomplishments in 2022, and John and Cheryl will add to these in their remarks. Overall, we believe the takeaway today for investors and analysts is that our strong execution in 2022 amid a challenging backdrop, coupled with our clear capital growth plan, it demonstrates American Water's ability to deliver on our long-term plan. I'm very confident we can execute our plans in '23 and beyond and the great -- with the great momentum we have from 2022.

Turning to Slide 6. As you can see, we have delivered an exceptional total shareholder return over the past five years, including our growing record of significant dividend increases. We're very proud of this history, which also compares favorably on a three-year look back for TSR.

I want to acknowledge, though, that our stock and water utility stocks in general did not perform as well in 2022 compared to the broader utility sector. Valuations of high PE stocks fell rapidly in the first half of 2022, as actual and expected interest rate hikes changed the landscape of investment opportunities. As a result, the PE multiple gap that had greatly expanded between water utilities and electric and gas utilities in recent years, narrowed in 2022. All of that, while we continued our very strong performance.

This chart shows clearly the impact of the macro environment we have been in and how it affected valuation without regard to specific performance. And as we've seen so far in 2023, this revaluing of the market has stabilized as many other macroeconomic drivers have stabilized, including interest rates. If this continues to hold true, I'm confident, our company's fundamentals and the execution of our strategies will drive shareholder value and very competitive total shareholder returns for many years to come.

Which takes us to Slide 7. The comments that we'll share today are an affirmation of the financial plan, targets and guidance we laid out last November. Later, John will recap the drivers for growth in 2023. But big picture, we believe the combination of our EPS growth, our strong dividend, and ESG premium, and the affordability of our service continues to be rewarded by investors and distinguishes us from others in the utility sector.

I'll remind you that we believe the runway for our growth and for achieving these targets is very long, certainly through 2027 in our five-year plan and beyond. This is primarily, of course, due to significant investments in infrastructure and regulated acquisitions. And as we get further into the plan, we'll see the full effect on earnings from the increased capital spending and continue our track record of success in the regulatory arena, we will deliver on our earnings growth plan and within the target range.

And with that, I'll turn it over to John to cover more detail on 2022 financial results, our '23 outlook and our financing plans. John?

John C. Griffith {BIO 22806522 <GO>}

Thank you, Susan, and good morning, everyone. Turning to Slide 9. I'll start by providing more details on our financial results for the year. In 2022, earnings were $4.51 per share compared to $6.95 per share in 2021. Fourth quarter and full year 2021 results included a gain of $2.70 per share from the sale of Homeowner Services, and the $0.19 per share contribution to the American Water Charitable Foundation from the proceeds of the sale. Excluding this net gain in 2021, earnings grew by $0.26 per share in 2022. Earnings on infrastructure investment were the key driver of the growth.

In 2022, we saw an increase of $0.89 per share related to higher revenues from new rates, acquisitions and organic growth. Also, as discussed last quarter, weather was favorable by an estimated $0.06 per share in 2022 and $0.04 net year-over-year due primarily to warmer and drier conditions in 2022. Revenues in 2022 were favorable to plan for the year due to healthy organic demand and favorable and timely rate case execution in addition to the favorable weather.

These factors, combined with expense management and lower pension costs as compared to plan, helped offset the impacts of inflation we experienced in 2022. Specifically, O&M and other expense increased by $0.31 per share year-over-year, with an estimated $0.23 of inflationary costs on chemicals, power and other fuel and higher interest rates. O&M and other also increased due to interest expense on new debt, state-level revenue taxes and insurance.

Depreciation expense also increased $0.14 per share in support of growth in the regulated businesses.

And as a reminder, 2021 results included $0.12 per share of operating earnings from our former New York subsidiary. The other operating segment results decreased in 2022, as the $0.31 per share of operating earnings from HOS in 2021 was mostly offset by $0.24 per share of earnings in 2022 from interest income and revenue share agreements.

Finally, I want to note that we have a slide in the appendix that provides some additional details on fourth quarter results, which were also on plan.

Turning to Slide 10. You'll see that in 2022, we had a strong year of business development growth as we closed on $335 million of acquisitions, which represents 70,000 customer connections across seven states. I think it's worth pausing for a minute to acknowledge the tremendous amount of work it takes across our state teams in collaboration with our corporate team to develop these opportunities, execute purchase agreements, and most importantly close on such a sizable number of acquisitions. The final statistics on any one calendar year's worth of acquisitions are often the result of many years of groundwork. We are confident, we are the right choice for communities in search of solutions to their challenges, and we will continue to drive that vision.

We are set up well for 2023 to be a strong year for growth through acquisitions. To start the year, we had $326 million of signed purchase agreements across nine states, which includes the Butler Area Sewer Authority, wastewater system in Pennsylvania we talked about last quarter. The integration work to add Butler's customers, operations and employees onto the American Water platform is progressing as planned. We expect to close on that acquisition by the end of 2023, pending regulatory approval and look forward to serving these new customers.

Of course, as we close on transactions, the work to build and refill the acquisition pipeline is continuous across our footprint. Our pipeline of over 1.3 million customer connections is a strong leading indicator that supports this piece of our earnings growth triangle.

Moving to a discussion of our financial health. On Slide 11, we provide a summary of our strong financial condition as we head into 2023. As a sign of continued financial strength, both S&P and Moody's have recently affirmed our credit ratings of A and Baa1, respectively, and with a stable outlook for both. We believe, our debt maturity levels, along with our planned debt issuances are very manageable. Our laddered approach to long-term debt financings over the years is important to minimize interest rate risk in a rising rate environment. I expect us to continue to issue fixed-rate long-term debt to protect against interest rate volatility.

For total debt-to-capital, which at year-end was just above our target of 60% or less, we expect a meaningful decrease in 2023 when we issue equity. And finally, on liquidity, we continue to remain confident that we will have sufficient access to capital for the foreseeable future.

Moving on to Slide 12. As Susan mentioned, we are affirming our earnings guidance for 2023 in the range of $4.72 to $4.82 per share. With our record of execution, we are confident in our ability to achieve our earnings expectations for 2023. The factors behind our 2023 guidance and long-term outlook are consistent with our messaging when we initiated 2023 guidance in November of 2022. This year's growth builds on the accelerated CapEx plan we put forth in November of 2021, which is driven by capital investment to serve our customers. Recent acquisitions that are being incorporated into active rate cases or just completed rate cases will also drive revenue and earnings growth this year.

The regulatory solutions we pursued in our recent cases and are pursuing in our active cases, such as cost deferrals and expense recovery mechanisms are closely aligned with the interests of our -- of regulators and customers. This approach helps to manage affordability and limit variability of customer bills, which ultimately aligns with our investors' interests as well. We are confident, that we have in place regulatory solutions for over 75% of the elevated costs we anticipate in the near-term, including certain production costs, interest and pension costs.

As it relates to pension costs, with our year-end pension obligation remeasurement completed, we now know the pension expense for 2023, and it is fully reflected in our unchanged 2023 EPS guidance range. Finally, 2023 results will benefit from MSG's successful addition of its first Navy contract that we announced last summer, which will be fully transitioned in March of this year.

Moving on to our financing plan. We continue to expect to issue an estimated $2 billion of equity from 2023 through 2027. Consistent with our prior messaging, subject to market conditions, we plan to raise a significant portion of the total planned equity in 2023. The remaining portion of the $2 billion of planned equity not completed in 2023 is expected to be issued near the end of the current five-year plan.

As we've said for several quarters now, we expect equity will be a regular financing tool to fund incremental growth in the investment plan and to maintain a strong balance sheet. We also continue to expect to raise capital annually in the debt markets, including later this year.

On Slide 13, we are affirming some more specifics regarding the key drivers for 2023 that I just discussed. These drivers are also generally consistent with what we shared last quarter and demonstrate the importance of our ongoing regulatory execution. Recent new revenue in Pennsylvania, New Jersey and Illinois, together with infrastructure surcharge mechanisms account for a significant majority of the $1.10 to $1.20 per share revenue increase in 2023, shown on this slide. Also reflected are the financing plans we expect to execute in 2023 that I just reviewed.

Wrapping up on Slide 14, I'll echo Susan on how we drive our growth strategy and our operating plans to achieve our company's targets and goals. For the communities we already serve and the communities we hope to serve in the future, the capital investment needs that are required to deliver more sustainable water and wastewater services are very large. It's up to us to find ways to balance these investment needs with the affordability of services for our customers.

As you've heard today, we are affirming our long-term earnings and dividend growth targets, and our other long-term financial targets remain unchanged. We believe, our 7% to 9% EPS and dividend growth targets are compelling and maintain our position in the top tier of growth in the industry. The combination of our growth outlook, supported by our significant yet low-risk capital investment plan as well as our ESG leadership premium and constructive position on affordability should continue to be rewarded by investors. Based upon this and our history of executing on our strategies, we expect to continue to deliver a very competitive, sustainable shareholder return for many years to come.

With that, I'll turn it over to Cheryl to cover our CapEx and rate base growth plan, rate case updates and more on ESG. Cheryl?

Cheryl D. Norton {BIO 17107572 <GO>}

Thanks, John, and good morning, everyone. On Slide 16, I want to start by acknowledging that our entire company did an excellent job of safely executing on our accelerated capital plan and safely performing our day-to-day work in 2022. While we didn't reach our ultimate goal of zero injuries, we did record our best year ever in terms of safety performance. That's quite an achievement, since 2022 was also a record year of total investment in American Water, and we experienced some extreme weather conditions. We slightly exceeded our $2.5 billion goal for the year by making prudent investment decisions across our footprint and by acquiring many new systems, which John spoke about earlier.

Looking ahead to 2023, and as we told you in November, we increased our investment plan this time to $2.9 billion overall, and roughly $2.5 billion for capital expenditures. This will likely be our new annual threshold for the next few years. Coupled with detailed project plans, we expect this pace of investment to drive improvements in water quality and reliability for the benefit of our customers.

These investments also generate significant economic benefit to the local and regional economies, while improving the environmental compliance of the systems and these communities. These investments should also favorably impact our pipe replacement cycles, which are much better than the industry average. Taken together, these actions demonstrate how the values of ESG are integrated into our everyday work.

Turning to Slide 17. I won't spend much time here, but this graph simply illustrates the result of our continued execution on capital investments. The combination of infrastructure projects and acquisitions is succeeding in growing our rate base at a long-term rate of 8% to 9%. Rate base growth, of course, will drive earnings growth as we make prudent investments in our systems with constructive regulatory outcomes.

Let's move to Slide 18 and review the major components of our 10-year capital investment expenditure plan. Our focus continues to be infrastructure renewal at 68% to 70% of the plan through 2032. These investments are primarily for pipe replacement and upgrading water and wastewater treatment facilities. We also expect to allocate 10% to 12% of our capital expenditures to resiliency in order to harden our systems, improve cyber and physical security, and address climate variability. This allocation has increased over where we've been historically.

Our resiliency has been tested over the past few months with floods in California and the bitter cold temperatures in many of our service territories over this past holiday season. And as Susan said earlier, our systems and our teams did a great job of weathering the storms and preventing any major service disruptions during these recent events. It shouldn't be lost on our investors or other stakeholders, that our employees in the field have the best skills, training and expertise in the industry, which leads to these great results when we're tested.

Our commitment to make needed investments to enhance water quality remains very strong, including steps we're taking to improve our comprehensive source water protection programs and upgrade our treatment facilities. Every water provider must be prepared to address a broader range of contaminants and be ready to meet more stringent regulations.

Finally, we'll continue to invest in new technologies to enhance our customer experience and enable our employees to drive efficiencies. Overall, our capital plan is very much aligned with our environmental goals and other ESG-related values that we prioritize as a company.

Let's go to Slide 19 and cover the latest regulatory activity in our states. Shown on this slide is a summary of pending or recently completed general rate cases with some key facts for each. In the appendix, you'll also find some details related to infrastructure surcharges as well as a snapshot of the key outcomes from the most recent general rate case in our top 10 states.

As Susan alluded to in her comments earlier, for us, the ability to execute on our regulatory strategies is a critical success factor for continuing to grow our business every year. However, we know that customer affordability is especially online of many utility investors and analysts heading into 2023, a topic I'll speak more about in a few minutes.

Because of these concerns, we believe our constructive rate case outcomes in 2022 should be tangible evidence of the support we have from regulators for needed infrastructure investments to deliver high-quality service to our customers.

The common thread in all of these general rate cases is the focus on recovery of infrastructure investments made since the last round of cases, totaling over $4 billion, and in some states, the roll-in of acquisitions. As we've said, though, there are infrastructure mechanisms in several of our states that are reducing the lag of regulatory recovery. This works alongside our timeframe between general rate cases of about two years in our bigger states.

Turning briefly to active rate cases. Our cases in California and Missouri were filed in July and are progressing as expected so far. In January of 2023, we filed an update in Missouri for costs and other needed elements of the case, with hearings to be held this month. We expect the case to reach conclusion by the end of the second quarter of 2023.

In California, we recently applied for a Water Resources Sustainability Plan, which is an update to the general rate case. This plan requests the continuation of a decoupling mechanism that stems from legislation the governor recently signed that allows the California Public Utilities Commission to consider a decoupling mechanism.

We believe, decoupling is a ratemaking strategy that's good for both our customers and for the environment because it rewards customers for conserving water as we make investments to renew and improve our drinking water infrastructure. The filing has also been updated with more timely customer demand estimates and to reflect present rates approved by the commission, effective January 1, 2023.

The application itself includes infrastructure renewals, wildfire mitigation, climate resiliency efforts and strengthening affordability programs in addition to the new Water Resources Sustainability Plan. And in Virginia, we have a settlement on file and expect a final decision in the first quarter of 2023.

On the regulatory front outside of general rate cases, there were a few notable developments since our third quarter call. Staying in California and relating to the Monterey Water Supply Project, in November the Coastal Commission approved our desalination coastal development permit application after many years of community discussion and in light of some additional commitments from us to the community.

Then in December, the California Public Utilities Commission issued its decision, that authorizes us to enter into an amended water purchase agreement and addressed rate recovery for the associated facilities.

Subsequently, we filed an application for rehearing, requesting inclusion of all infrastructure costs in the cost cap for the groundwater replenishment project expansion, and requested AFUDC that was not included in the decision. We are awaiting a ruling on our application.

American Water is committed to being a solutions provider to the communities in Monterey County, both through the advances in the water supply project and through maintaining our current level of operations in the area. Just last month, several communities in Monterey were impacted by evacuations due to flooding that occurred there. Because of our amazing employees and reliable assets, California American Water, maintained normal service to its customers during this challenging time. Finally, in California, we're still awaiting a ruling from the Commission on the pending cost of capital case.

Switching gears to Pennsylvania. Last month, the Department of Environmental Protection issued a maximum contaminant standard for two PFAS chemicals. Based on our proactive testing, we've identified one American Water location in Pennsylvania that requires action based on the new regulations. The treatment upgrade for that facility was already in process and is anticipated to be online later this year. In the meantime, we've taken the contaminated well out of service temporarily to manage PFAS levels in the water provided to our customers, and ensure early compliance with the new regulations.

We are still awaiting the new U.S. EPA standards, which we anticipate will be delivered later this year. We've already performed significant testing and analysis across our systems in compliance with state-level guidance and have been acknowledged for that work, which will help inform our action plans when the EPA issues its standards. For example, our Short Hills Station project in New Jersey was completed to meet New Jersey state regulations and was recognized with the Governor's Environmental Excellence Award in 2020 for its leadership in water treatment related to PFAS removal.

Broadly, we believe we are the leaders in the industry on this topic, as evidenced by our work with the Water Research Foundation on PFAS communications and other projects. Our research scientists are frequently invited by the EPA, Newark [ph], AWWA, and the Water Research Foundation to speaking engagements that inform stakeholders and colleagues in the water industry.

Finally, we were honored to be the only private utility invited to a recent event at the White House, focusing on reducing lead exposure. Replacing both the companies and customers' portions of lead service lines is a part of our current capital plan. Our goal is to replace a significant majority of known lead service lines in our service areas by the year 2030.

To show the magnitude of our regulatory execution efforts, you can see on Slide 20 that we have $416 million in annualized new revenues and rates since January of 2022. This includes $308 million from general rate cases and step increases, and $108 million from infrastructure surcharges. We have $181 million of total annualized revenue request pending, which includes two infrastructure surcharge proceedings.

Throughout the remainder of the year, we expect to file additional general rate cases to cover infrastructure investments and acquisitions since the last cases. As always, execution on these regulatory priorities is key to our plan for growth in the business. Because we make prudent investments and have skilled and dedicated employees working on these cases, we're very confident in obtaining constructive outcomes as we did in 2022.

On Slide 21, as I mentioned earlier, customer affordability is front-and-center in the utility industry in 2023. One of the most difficult challenges we face in the water and wastewater industry is balancing customer affordability with the magnitude of the system investments that are needed. Thankfully, as we now have another full year's data to reflect on, our company is still in a very good relative position in terms of affordability or wallet share at less than 1% of median household income. We continue to believe that our affordability proposition is an important differentiator.

And finally, on Slide 22, I'd like to highlight an ESG story that is a bit different than others -- than the others we have shared this past year. We're proud to say that American Water earned the SAFETY Act designation from the Department of Homeland Security in 2022, the first water and wastewater company to do so. Not only is this great recognition of the work we do every day to keep our employees and communities safe, but it also gives us the opportunity to strengthen our processes and increase knowledge sharing with the U.S. government.

So with that, I'll turn it back over to the operator, and begin Q&A, and take any questions you may have.

Questions And Answers

Operator

(Question And Answer)

Yes. Thank you. At this time, we will begin the question-and-answer session. (Operator Instructions) At this time, we'll pause momentarily to assemble the roster. And the first question comes from Richard Sunderland with J.P. Morgan.

Q - Richard Sunderland {BIO 20365913 <GO>}

Hi, good morning. Thank you for taking my question.

A - M. Susan Hardwick {BIO 16618718 <GO>}

Good morning, Rich.

Q - Richard Sunderland {BIO 20365913 <GO>}

Maybe starting with the equity update. I know you reiterated a similar language to 3Q, but just now that we're getting into 2023, I just wanted to see if there's anything else you could share on kind of timing or message as we're into the calendar year now.

A - M. Susan Hardwick {BIO 16618718 <GO>}

Yes. Hey, Rich. Thanks for the question. I'll ask John to comment on that.

A - John C. Griffith {BIO 22806522 <GO>}

Rich, no update in terms of timing. We'll issue the bulk of the $2 billion in 2023. And then whatever we don't issue in '23, we'll issue in the back-end of our 2023 to 2027 plan period.

Q - Richard Sunderland {BIO 20365913 <GO>}

Okay. Got it. Very clear. Thank you. And then you noted the stabilizing chemical costs, and I see the differences in the '23 walk from 3Q and then the current tech. But just, is that really the -- looking at, I think, is a $0.01 revision there on the total range. Is that really the change you're seeing versus the initial assumptions? I guess, what I'm really getting at is across that and pension, any kind of movement within the guidance range now that you have final marks and more line of sight on the chemicals front relative to your initial outlook?

A - M. Susan Hardwick {BIO 16618718 <GO>}

Yes. Rich, I'd say, no change from what we've previously discussed, both in terms of our results in '22 and expectations for '23. As we talked last quarter, pretty successful in the regulatory arena to really mitigate most of that exposure going into '23. And now that we finished our pension remeasurement, as John commented on, certainly anticipate no change to our guidance relative to that issue.

Q - Richard Sunderland {BIO 20365913 <GO>}

Got it. Very clear as well. Thank you for the time today.

A - M. Susan Hardwick {BIO 16618718 <GO>}

Thanks, Rich.

Operator

Thank you. And the next question comes from Gregg Orrill with UBS.

Q - Gregg Orrill {BIO 21090160 <GO>}

Yes. Hi. Thank you for taking the question. Hey, to follow-up on the equity, just how does that position you for incremental acquisitions? Is there sort of a -- any element of prefunding there? And then if there's -- and a follow-up, just on the rate base, how did that come in for 2022 versus your expectation? And how does that -- if it's different, how does that impact your guidance going forward?

A - M. Susan Hardwick {BIO 16618718 <GO>}

Let me take the first -- or the second part of that first. No surprises relative to rate base as we ended the year. And again, as we look out really into this five-year period, we don't expect any changes from what we've previously shown you around rate base.

And John, you want to comment on the equity question?

A - John C. Griffith {BIO 22806522 <GO>}

Sure. Gregg, I would just say that the amount of equity that we're raising and the cadence of the equity does capture the various scenarios that we've run around regulated acquisitions.

Q - Gregg Orrill {BIO 21090160 <GO>}

Appreciate it.

A - M. Susan Hardwick {BIO 16618718 <GO>}

Thanks, Gregg.

Operator

Thank you. And this concludes our question-and-answer session. The conference call has now concluded as well. Thank you for attending. You may now disconnect.

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