Q2 2023 Earnings Call

Company Participants

- Aaron Musgrave, Vice President, Investor Relations
- Cheryl D. Norton, Chief Operating Officer
- John Griffith, Chief Financial Officer
- M. Susan Hardwick, President, Chief Executive Officer, Director

Other Participants

- Agnieszka Storozynski, Analyst, Seaport
- Gregg Orrill, Analyst, UBS
- James Kennedy, Analyst, Guggenheim Partners
- Paul Zimbardo, Analyst, Bank of America

Presentation

Operator

Good morning, and welcome to the American Water's Second Quarter 2023 Earnings Conference Call. As a reminder, this call is being recorded and is also being webcast within the accompanying slide presentation through the company's Investor Relations website. The audio webcast archive will be available for 1 year on American Water's Investor Relations website.

I will now like to introduce your host for today's call, Aaron Musgrave, Vice President of Investor Relations. Mr. Musgrave, you may begin.

Aaron Musgrave {BIO 22474483 <GO>}

Thank you, Sasha. Good morning, everyone, and thank you for joining us for today's call. 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 second quarter earnings release and in our June 30 Form 10-Q, 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 diluted earnings per share.

Susan Hardwick, our President and CEO, will share highlights of second quarter and year-to-date results and thoughts on our affirmed 2023 EPS guidance and longer-term targets. John Griffith, our Executive Vice President and CFO, will discuss our successful financing activities in the first half of the year, cover our financial results in more detail, and we'll close with an update on our acquisition activity. Cheryl Norton, our Executive Vice President and COO, will then discuss our capital investment plan, regulatory updates and will conclude with a review of our recently published sustainability report and other new disclosures. We'll 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, Aaron, and good morning, everyone. Let's turn to Slide 5, and I'll start by covering some highlights of the first half of the year. As we announced yesterday, we delivered strong financial results in the second quarter and the first half of 2023. Earnings were $1.44 per share for the quarter compared to $1.20 for the same period last year.

In the first 6 months of 2023, earnings were $2.37 per share compared to $2.07 per share in the same period of 2022. The results were in line with our expectations as we knew the first half of the year would be strong compared to last year due to revenue increases from several general rate case proceedings completed in '22, and in early '23 and from infrastructure mechanism filings.

We continue to execute on our regulatory strategy, which continues to be the key driver of our results. Revenues in the second quarter were also higher due to increased usage from warm and unusually dry weather in several of our states. Tempering results were higher operating costs, which John will elaborate on further.

Moving on to some of our other key accomplishments so far in 2023. We invested nearly $1.2 billion in capital projects year-to-date, reflecting great work by our teams responsible for planning and completing these investments. Also, as you will recall, the total capital investment plan for 2023 includes approximately $400 million for acquisitions, including 2 sizable transactions we expect to close in the fourth quarter.

Our outlook for future acquisitions remains strong as we have over $550 million of acquisitions under agreement, including those 2 sizable deals. As we announced in March, we completed a very successful equity issuance of $1.7 billion of American Water common stock. This delivered on the highest priority in our 2023 financing plan.

And as we announced last month, we completed a convertible debt issuance of just over $1 billion that achieved the other key element of our 2023 financing plan. Finally, earlier this week, we were pleased to publish our company's latest sustainability report. Cheryl will share a few highlights of the report, but at its core, it tells the story of how we are fulfilling our mission of providing safe, clean, reliable and affordable water and wastewater service in a very sustainable way to American Water customers. And this has been our mission for over 135 years.

Turning to Slide 6. We are affirming our 2023 EPS guidance range of $4.72 per share to $4.82 per share on a weather-normalized basis. And once again, we are affirming our long-term targets. I continue to believe that our regulatory -- our strong regulatory financing and operational execution is the differentiator from our peers. Our track record of executing on these fronts gives us confidence and should give investors' confidence in our ability to achieve our short-term and our long-term financial targets. As we've done in the past, we expect to consistently grow earnings and dividends at a top-tier pace over the next 5 years and beyond.

And with that, I'll turn it over to John to cover some second quarter highlights and financial results in more detail. John?

John Griffith {BIO 22806522 <GO>}

Thanks, Susan, and good morning, everyone. Turning to Slide 8, I'll start by reviewing the successful completion of our 2023 financing plan. As Susan mentioned, and as I covered on the last call, earlier this year, we completed an upsized equity offering for proceeds of $1.7 billion. The remaining portion of the $2 billion of our currently planned equity is expected to be issued near the end of this 5-year plan, as we've previously communicated.

Then last month, we issued just over $1 billion of exchangeable senior notes due in 2026 with an annual interest rate of 3.625%. As we previously disclosed, this exchangeable debt issuance supports our long-term growth as a diversified low-cost funding source that benefits customer affordability and shareholder value. Upon any exchange of the notes, the principal amount will be settled in cash with flexibility to settle any remaining value above the principal amount in cash, shares or a combination thereof at our election. We used the proceeds from both of these transactions to bring our commercial paper balance to zero by quarter end with almost $800 million of cash yet to be utilized, that is earning interest.

With our 2023 long-term financing needs now complete, our balance sheet is well positioned to fund our robust water and wastewater investment growth. On Slide 9, we provide a summary of our continued strong financial condition, our total debt-to-capital ratio, net of cash on the balance sheet remains at 54% as of June 30, which is well below our target of 60%. We believe our current debt maturity levels in conjunction with future debt needs are very manageable. And I would remind you, as shown on this slide, of the $720 million of no proceeds that we will receive in 2026 from the sale of HOS completed in 2021. Our laddered approach to long-term debt financings over the years is important to manage cash flows and minimize interest rate risk.

And finally, on liquidity, we remain confident that we will have sufficient access to capital for the foreseeable future. Turning to Slide 10. I'll provide some further insights into our financial results for the quarter. Earnings were $1.44 per share for the quarter of $0.24 per share versus the same period in 2022, and up $0.17 per share on a weather-normalized basis.

As you know, we have completed rate cases recently in our larger states and are seeing the increased revenues as a result. These additional revenues are driven by the significant investments we have made and continue to make in our systems. As noted, earnings were higher in the quarter by an estimated $0.07 per share due to weather in 2023 due to warm and dry conditions, primarily in Missouri, New Jersey and Pennsylvania. But we did see unusual weather in the quarter resulting in higher throughput, which we typically don't see during this time of year, our investments in resiliency and our proactive communications to customers around water conservation, ensured that we did not experience any significant operating issues during the quarter. And looking at operating costs, higher pension expense of about $0.04 per share and increased chemical costs of about $0.03 per share, including inflationary pressures were largely mitigated by the higher revenues.

Based on the current outlook, we are not expecting the cost of chemicals to decrease in the near term as demand remains elevated. Our operating costs in the second quarter also increased due to a higher employee headcount to support growth in the business. As we've said, our proactive strategy last year to seek rate [ph] of rising production costs and expected higher pension costs has positioned us favorably to limit the bottom line impact of those higher costs in 2023.

This approach continues in our recently filed cases. Supporting our investment growth, depreciation expense increased $0.06 per share and the cost of additional long-term financing increased $0.11 per share primarily related to share count dilution. As I mentioned last quarter, the EPS impact of the higher share count from our equity issuance offsets the avoided expense and the current interest rate environment. We expect the impact to be approximately neutral to EPS for the full year as well based on the current outlook.

Turning to Slide 11. Earnings increased $0.30 per share for the year-to-date period compared to the same period last year driven by many of the same factors as in the second quarter. On a weather-normalized basis, earnings have increased $0.23 per share year-to-date, which, as Susan mentioned, is in line with our expectations for the first half of the year.

Before we look at our expected full year 2023 EPS details, I should note that, as you would expect in the year of an equity issuance, our quarterly EPS results may not sum to equal the year-to-date EPS results each quarter. This is simply due to a different amount of average shares outstanding used in the EPS calculations as the year progresses.

Turning to Slide 12. I'll echo Susan's comments that our results remain on track to achieve our 2023 EPS guidance of $4.72 to $4.82 per share on a weather-normalized basis. Here, we provide some updated details related to 2023 guidance that reflect results so far this year, including the completed 2023 financing plan. You can see, for example, that our implied revenue growth for the second half of the year will be strong, though somewhat less than the first half growth as new rates became effective in New Jersey last September.

Looking ahead, I am pleased that we have the right fundamentals in place, including our strengthened balance sheet to achieve our long-term financial targets, which we are also affirming today. Turning to Slide 13, you'll see that we are set up for strong growth through acquisitions in 2023 and beyond. We closed on 10 acquisitions totaling $33 million across 5 states in the first half of 2023, which demonstrates our continued ability to close deals in many states.

We also had 32 transactions under agreement across 10 states through the end of June totaling $555 million and includes both the Butler Area Sewer Authority, wastewater system in

Pennsylvania, and the Granite City wastewater treatment plant in Illinois we previously announced. We now expect to close both of these transactions near the end of 2023 pending regulatory approvals for each. Also included in our acquisitions under agreement is the Towamencin Township Wastewater System in Pennsylvania, we expect to purchase for $104 million as announced back in March. We continue to expect to close on Towamencin by midyear 2024, pending regulatory approval, and we look forward to serving all of these customers.

Of course, as we close on transactions, the work to build and refill the acquisition pipeline is continuous. Our pipeline of over 1.3 million customer connections is a strong leading indicator that supports this piece of our earnings growth triangle. With our track record of closing on acquisitions and executing on our CapEx plans, we are confident that we will achieve our capital investment plan of $2.9 billion for 2023. And when you combine that with the financing we have already completed to fund growth, we believe our outlook for 2023 and beyond is very attractive for investors.

With that, I'll turn it over to Cheryl to talk more about our capital investment, rate case and other regulatory updates. Cheryl?

Cheryl D. Norton {BIO 17107572 <GO>}

Thanks, John, and good morning, everyone. I'll start by commenting on our continued focus on investing in our systems. Slide 15 shows a recap of our capital investment so far in 2023. As John said, we remain on plan to meet our goal of approximately $2.9 billion of total capital spending for the full year.

Our state teams continue to execute each quarter on the multitude of projects that improve our systems. Two examples of the types of projects we're working on are improvements to the lime softening system, chemical facilities and filters at the Jerseyville, Illinois Water Treatment Plant [ph] treatment plan and enhanced variation capabilities and other digester improvements at the Coatesville water treatment plant in Pennsylvania. These renewal and improvement projects are typical examples of how the capital we deploy is essential to our mission of providing safe, clean, reliable and affordable drinking water and wastewater services. And finally, as John mentioned, our larger acquisitions in 2023 are expected to occur in the second half of the year as compared to 2022, when the first half of the year included our largest acquisition for the year, over $200 million for the City of York's wastewater system.

Let's go to Slide 16 and cover the latest regulatory activity in our states. Shown on the slide is a summary of our pending general rate cases with some key facts for each. In the appendix, you'll also find some details related to infrastructure charges as well as a snapshot of the key outcomes from the most recent general rate case in our top 10 states. Sharing with our -- starting with our general rate cases in California and Indiana, both are progressing as expected. In Indiana, hearings are expected in early fall, which follows testimony filed by all parties in July and August. In California, we expect hearings in the fall as well. At the beginning of May, we filed a general rate case in West Virginia, reflecting $340 million in water and wastewater system investments covering 2020 through 2025.

We are seeking $45 million of additional annual revenue, excluding infrastructure surcharges, we would expect an order in February of next year. At the end of June, we filed a general rate case in Kentucky reflecting $330 million in water system investments since the last rate case order in 2019. We are seeking $26 million of additional annual revenue, excluding infrastructure surcharges to support continued safe and reliable service and recovery of increased production costs.

We would expect an order in this case in February of next year. In Missouri, we were pleased to receive a final decision from the Missouri Public Service Commission in May. The negotiated settlement reflects the increase of $95 million in annualized revenues, including $51 million for previously approved infrastructure surcharges.

Though not specifically noted in the order, our view of the return on equity allowed is 9.75%, and the equity ratio is 50%. Outside of general rate cases, the California Commission issued a decision on June 29 on California American Water's 2021 cost of capital application authorizing an 8.98% ROE with an equity component of 57.04%. The decision was not retroactive and will be effective through the end of 2024.

The following day, we filed an advice letter as authorized by the state's water cost of capital mechanism seeking a 52 basis point increase to our ROE in 2023, which was approved on July 25, increasing the return on equity to 9.50% effective July 31. As Susan mentioned, our regulatory execution is a key driver of our results and our team continues to do an excellent job. As we previously discussed, we submitted written comments on the federal EPA's proposed PFOS rule in May.

The key concern that we voiced is that EPA's cost estimates are materially understated. Our internal and preliminary estimates show that capital investments in excess of $1 billion will be needed by American Water, along with nearly $50 million of annual operating expenses in order to comply with the rule as currently proposed. We are still evaluating the potential impact of our 5-year capital plan, including whether PFOS will drive incremental CapEx in the plan or if some currently planned projects will be completed later beyond the 5-year horizon or both.

We expect to have more to share on that in the third quarter earnings call. Related to ongoing PFOS litigation and the announcement of some settlements with manufacturers of PFOS, we are a long way from knowing what these settlements mean for our customers, including if, how and when funds from these settlements or other litigation may ultimately be distributed. We will continue to advocate that the ultimate responsibility for the cleanup of these contaminants should fall to the polluters, and we will continue to work cooperatively with the EPA and with Congress, regulators and policymakers in support of water quality standards that protect customers and communities balanced with affordability.

Another topic that's been in the news recently is around certain telecommunication companies and their historical usage of lead insulated cables. While these stories don't relate to American Water, we'd remind you to review the disclosures we've had for many years in our Form 10-K around the replacement of lead service lines in our regulated service territories. We are in great shape related to that replacement program.

Finally, on Slide 17, earlier this week, we released our latest sustainability report covering the years 2021 and 2022. This report highlights our commitment to excellent water quality, customer affordability and continued investing in water and wastewater infrastructure and our sustainable business practices and values that align with these commitments. To demonstrate our ESG leadership and commitment to transparency, we also continue to expand and update disclosures related to how we operate the business, some of which we've referenced here. And we're pleased to continue to be recognized by leading ESG rating services such as MSCI for our actions and our disclosures in this space.

One final comment before I wrap up. As you know, there have been several weather events this quarter, including the severe flooding in New York State. While we no longer have regulated utility operations there, we do operate the water system and 2 wastewater treatment plants at U.S. Military Academy West Point through our Military Services Group business. Our teams there went above and beyond to ensure West Point could continue to operate and have continued access to safe and reliable water and wastewater services, and we did so safely. Our teams across the entire business are experts at what they do every day. We thank them and are grateful for their commitment and expertise in delivering to those we serve and doing so in a safe and sustainable way.

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

Questions And Answers

Operator

(Operator Instructions) The first question comes from the line of Paul Zimbardo from Bank of America. Please go ahead.

Q - Paul Zimbardo {BIO 18277958 <GO>}

Hi, good morning. Thank you, Tim.

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

Good morning, Paul.

Q - Paul Zimbardo {BIO 18277958 <GO>}

Great. The first question I had was, I know there was a good number of changes on the drivers within full year '23 guidance. If you could just unpack like where were you seeing that better revenue net O&M strength in the year-to-date or second half, wherever it lands.

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

Yes. Let me comment first and certainly, John can add to it. I think really it's -- you can look on the revenue side, primarily timing of rate cases and the resulting revenue increases and then also additional costs that we have built into those rate cases. We've been talking quite a bit about inflationary impacts and higher chemical costs and production costs, and we've been successful in getting those higher costs built into a number of the cases we did last year.

And as those cost increases have gone up, the associated revenue recovery has gone up. So I'd say those are the primary drivers. On the sort of financing cost side, those changes really driven by just the timing of primarily this long-term debt issue we just did and then higher costs associated with short-term debt financing. I think, John, that probably covers the main ones. Any other items to add?

A - John Griffith {BIO 22806522 <GO>}

Yes, I think it does. That's right. Paul, we started to pick up New Jersey revenue last September, so that moderates year-over-year growth. And I'd say on from an inflation perspective, we're starting to see production costs moderate as we've come through the second quarter here.

Q - Paul Zimbardo {BIO 18277958 <GO>}

Okay. Great. And then on the balance sheet side, I know a great job cleaning up, taking out all that short-term debt. On the long term, 1 question I had was, I noticed you changed the language slightly to equal to or less than 60% debt to total cap versus before it's just less than 60%. Does that mean you anticipate that trending up closer to 60%? Just overall thoughts on kind of where you stand on that going through the long-term plan?

A - John Griffith {BIO 22806522 <GO>}

Yes. Paul, no real change there as we're thinking about it. As you know, we're raising financing in a periodic sort of manner. So we do expect to trend up over time until we reset again with equity, but no significant change there.

Q - Paul Zimbardo {BIO 18277958 <GO>}

Okay great, thanks a lot.

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

Thanks, Paul.

Operator

The next question comes from Angie Storozynski from Seaport.

Q - Agnieszka Storozynski

So first, maybe -- you mentioned the rainy July in New York State. I mean it's for us living in the Mid-Atlantic, it seems like it's been the weather pattern in New Jersey and Pennsylvania as well.

So is there any sense how -- if there's an offset to that $0.07 weather benefit from the second quarter thus far in the third quarter?

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

Yes, Angie, we don't have any sort of prediction so far on impacts in July. I'd just remind you again that our outlook for the year remains on track to hit our expectations, again, on a weather-normalized basis. So just a bit early to tell what impact July may have across the entire territory.

Q - Agnieszka Storozynski

Okay. Secondly, the exchangeable bonds that you guys did, I mean they came at a low coupon likely -- I mean, probably not something that you have considered in your guidance. So should I think that it's actually a benefit to guidance? And also, how does that tie up to the financing of those 2 big acquisitions that you expect to close later this year? Were they always planned to close still in '23. Again, I'm just trying to see if there's any benefit from an interest expense perspective.

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

I'll answer the second part first and then ask John to sort of come the financing impacts. We continue to look very closely at the timing of those 2 transactions. And we've always expected them to be sort of at or close to year-end. That's still our expectation. That's been built in our plan all along. The regulatory process is a bit unpredictable, but we feel confident about the ability to get those wrapped up right towards the end of this year. John, you want to comment on the financing piece.

A - John Griffith {BIO 22806522 <GO>}

Angie, I would just say on the financing piece that we set our plan last fall at a time when we can't predict interest rates. And I think where we've come out on the convert is consistent with our guidance and our affirmation of 2023.

Q - Agnieszka Storozynski

Okay. And my last question on the municipal M&A. So you've been very successful at those very large acquisitions even though some other companies have stumbled from those. Is this very much sort of a deal specific issue. So there's no any deterioration in the regulatory environment or the receptivity of municipalities to sell large assets? I mean, again, we're trying to see if there's a trend, you seem to be way more successful than others in large municipal M&A?

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

Yes. I think, Angie, I'll say what I always say here, I think we are very good at it. I think we spend a lot of time in these communities, cultivating the relationship. Our teams are very much embedded in these communities. I think they work closely with communities to define the need and to come up with the best solutions to meet those needs. I think that is continuing to be our strongest asset as it relates to acquisitions. I think the prospect for deals also continues to evolve. And I'd say these larger deals have come about I think because circumstances warranted. It doesn't signal a change in our strategy. It doesn't signal a change in what I believe to be the environment either for opportunity or regulatory acceptance or enthusiasm for deals generally. So I'd just say they're circumstantial, and our expertise, I think, continues to be a real advantage we have here.

Q - Agnieszka Storozynski

Okay, thank you.

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

Thanks, Angie.

Operator

The next question comes from Gregg Orrill from UBS. Please go ahead.

Q - Gregg Orrill {BIO 1532939 <GO>}

Yes, thank you, good morning.

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

Good morning, Greg.

Q - Gregg Orrill {BIO 1532939 <GO>}

Regarding the Indiana rate case proceeding on schedule, are you expecting revenue recommendations from interveners? So is that coming up?

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

Well, I think the normal process would be to have testimony filed with all the parties in the case, sort of later this summer, early fall. So I think the normal process, we would expect to see sort of full recommendations or positions taken by the various parties through that process.

Q - Gregg Orrill {BIO 1532939 <GO>}

Okay. Sort of traditional process like other places?

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

Yes. Yes, really nothing different.

Q - Gregg Orrill {BIO 1532939 <GO>}

Got it. Thank you.

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

All right. Thanks, Greg.

Operator

The next question is from Shar Pourreza from Guggenheim Partners. Please go ahead.

Q - James Kennedy {BIO 6070691 <GO>}

Hey, good morning. It's actually James on for Shar. I guess, just -- First question was just on the PFAS figures, so the $1 billion. I guess, could you just speak to maybe the puts and takes as it relates to your ability to update with the capital plan on the third quarter call. What, I guess, a little bit more color on how we should think about what of that $1 billion can roll into the forthcoming plan?

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

Yes, it's a good question and it's something obviously we're continuing to work on. And Cheryl alluded to this in her comments, we would expect to have quite a bit more visibility on our third [ph] quarter call, partly because our evaluation is certainly ongoing and our continued analysis of our various facilities to see where we may have exposure and what sort of treatment may be necessary. So that process is continuing.

But I'd also just say this is the time of year where we're doing all of our work relative to our financial plan. All the various updates throughout the business, and our capital planning is certainly a big part of that. So our normal cadence would be to continue to work through that planning process and be complete with it in the early fall with the expectation that we would roll out our guidance and expectations for the next year and then the next 5-year and even 10-year outlook relative to capital when we get to that third quarter call.

So we're just on sort of a normal cadence from a planning perspective. And then, as I said, on the evaluation of potential exposure. We're just still in the process of doing that work. And Cheryl, anything to add there?

A - Cheryl D. Norton {BIO 17107572 <GO>}

No. I would just say that we also continue to collect samples at all these locations to just verify what the levels are and look for any seasonal kinds of variations and such as that. So we're still drilling into the details, but as Susan said, as we go through our regular planning process, we're using our prioritization models and deciding what could we move out or not move out. And so it's a lot of work and the teams really dug into the details right now.

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

.Yes. And I think that is the key. We just need to complete that risk analysis piece, and we'll see how much of this $1 billion ultimately results in incremental capital expansion of the plan versus just shifting to later periods, shifting other work to later periods.

Q - James Kennedy {BIO 6070691 <GO>}

And I guess just the follow-up to that, too, is just the -- so we've got a few different regulations, EPA, a little uncertain over the circular designations. But has any of this changed your near-term approach to wastewater M&A?

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

No, I don't think so. We're continuing to look at that as a very important part of our strategy and continuing to look at those opportunities. We think there's a good set of opportunities in that space, largely driven again by just the aging infrastructure and how many of those systems were built initially and then many of them coming to sort of the end of their useful life. So we think the opportunities are plentiful. I would say it doesn't change our strategy relative to that. But I do think, as we think about sort of total capital allocation and from a risk perspective and a growth opportunity perspective, we'll manage all of those opportunities within our capital financing capabilities.

Q - James Kennedy {BIO 6070691 <GO>}

Thanks guys.

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

Thank you.

Operator

This concludes our question-and-answer session. The conference call has now concluded. Thank you for attending. You may now disconnect your lines.