ELCO
Management Company, LLC

January 26, 2018

Water Opportunities Separately Managed Account Program (WO SMAP)
December 2017 Update

The Water Opportunities Separately Managed Account Program continued to perform positively for the quarter ended December 31, 2017.

The main underlying thesis for investing in U.S. water utility/infrastructure stocks is their ability to steadily invest increasing amounts of capital and earn regulated returns which drives steady earnings and dividend growth. Hundreds of billions of dollars in investment is needed to improve America's water and wastewater infrastructure.

Earnings growth accelerated into the 2nd half of 2017 for non-regulated US water stocks. Backlog and order books in many individual companies are signaling these positive growth trends and should continue into 2018, in the low to mid-single digit range. With restructuring plans put in place by a number of the portfolios' companies over the past several years, our universe is leaner than ever, and stable growth should lead to strong margin improvement and double digit earnings per share growth. Additionally, many of these companies also have a significant tailwind from US tax reform, as many industrial water companies have 40% or more of their pre-tax income earned domestically in the United States. Within this group, the median company earned ~62% of its pre-tax income from domestic operations and the median company-wide tax rate was 32% prior to tax reform. Applying the new 21% corporate tax rate to domestic earnings and also assuming a slightly lower benefit from state and local tax deductions leads to a median 13% earnings accretion for this group of domestic water companies. Others which have 100% of their earnings generated from domestic operations will see an earnings benefit close to 20%. Importantly, this earnings improvement should flow through directly to free cash flow.

Another benefit from tax reform comes from the ability to expense in year one, 100% of capital investments for tax purposes, and continue to utilize this deduction each year for 5 years. For many industrial water companies, this is an additional benefit to free cash flow as cash taxes are reduced by this additional deduction. With 100% expensing in effect for domestic capex, along with lower tax rates, the median cash flow benefit to our companies is 15%. This additional cash flow presents a huge opportunity to return cash to shareholders, raise dividends, or smart M&A. While generating cash flow is very important, it is equally important that this cash is used to generate additional shareholder value, and we are very focused on investing in companies that have a proven track record of using free cash flow to further enhance shareholder value. We also think this additional cash generation should lead to a very active M&A market in 2018, which could benefit a number of our shareholdings. Positions such as frac water service provider Select Energy, water infrastructure manufacturers Mueller Water and Rexnord, and pump and water analytics provider Xylem should all benefit from their

200 Park Avenue
Suite 1700
New York, NY 10166
212.603.7585
646-403-4860 (fax)
msantos@elcomanagement.com

significant US exposure and lower corporate tax rates. The impact to earnings for these companies ranges from 4% to 19%, while the impact to free cash flow ranges from 6% to 20%. In most cases, rising interest rates have not hurt water utilities shares in past cycles. In fact, many water companies have demand profiles that are not directly economically sensitive.

In conclusion, scarce clean water with its positive long term pricing power and imbedded inflation protection stands in stark contrast to the glut conditions exacerbated by technology advancements and software disruption in other major asset classes such as power, transportation, retail, real estate, manufacturing, and insurance, to name a few.

If you have any questions, please feel free to contact us.

Paul Elliot, CFA *Dan Tulis, CFA*

James Elliot, CFA *Paul Doran*