Magellan – In The Know: Episode 32

American Water – a pipeline to dependable returns

Announcement (00:00):

The information contained in this podcast is for general information purposes and does not constitute investment advice. You should seek investment advice tailored to your circumstances before making an investment decision.

Host (00:14):

This is In the Know, a Monthly Investment podcast, brought to you by Magellan Asset Management.

Susan Hardwick (00:20):

From an investor standpoint, we're going to be doing this for the next 115 years, spending 3 billion a year, investing in the systems, going through the regulatory process, getting recovery and earning that roughly 10% return on that investment. So from an investor perspective, this is the best game going, in terms of stability and just long-term view and predictability of results.

Host (00:46):

That's Susan Hardwick, the president and CEO of American Waterworks, the biggest publicly listed water utility company in the United States, outlining the company's long view and reliability over time. Welcome to Magellan In the Know this episode. Susan Hardwick is joined by Magellan Infrastructure portfolio manager Jowell Amores for an insightful discussion about why American Water is one of Magellan's best performing investments, as well as the company's long-term approach. They discuss the business strategy that has seen American Water grow its earnings at a compounding rate of 11% a year since its IPO. It really is a fascinating dive into the world of water and other utilities. But first, here's a warm welcome from Jowell Amores.

Jowell Amores (01:38):

Welcome to our podcast Magellan In the Know. I'm Jowell Amores, a portfolio manager in the infrastructure team here at Magellan, and I'm joined today by Susan Hardwick, president and CEO of American Waterworks, which is the largest investor-owned water utility in the United States, and they provide water and wastewater services to more than 14 million people across 24 states in the US. Welcome, Susan.

Susan Hardwick (02:02):

Thanks, Jowell. Great to be with you today.

Jowell Amores (02:04):

American Water's been a portfolio holding for over a decade, and has generated some of the most attractive, and more importantly, most consistent returns in our investible universe. Earnings growth has compounded at an average rate of 11% per year since the company IPO'd in back in 2008. Just in the last 10 years, as at the end of 2022, American Water has rewarded their patient investors with total shareholder returns of 400%, well ahead of the S&P 500's 227% return. Now that's incredible considering what we've been through over the last five years. So perhaps before we get started, Susan, can we begin by asking you to tell us a bit about it yourself? Tell us a bit about the journey you've taken to get where you are today, how you went from entering the wild and fast-paced world of accounting to now heading up the largest water utility in the US.

Susan Hardwick (02:59):

Well, certainly, Jowell, you make it sound exciting, so I appreciate that, and thank you for having me today. I'm thrilled to be here, thrilled to have the opportunity to speak with your investors about American Water and about all of the things that we have accomplished in the past, and what we're looking forward to continuing to deliver, going forward. For me, I've been with American Water about four years. I came here post my career at Vectron Corporation, another utility in the space. A gas and electric company headquartered in Indiana. And prior to that, I was with Synergy, which of course is now Duke. So I've been in the utility industry virtually my entire career. When we sold Vectron in 2019 to Centre Point, I had every intention of retiring at that point, but really wasn't quite ready, and it sounded like a great opportunity. And as it turned out, it really has been a terrific opportunity for a number of reasons.

(03:50):

I joined American Water in 2019, began working with the team then to round out the financial organisation. Then we had a pandemic, and then our CEO at Walter Lynch, who was the CEO shortly after I joined the company, actually suffered an injury. Walter's fine now, fully recovered, but after that recovery, he decided it was time to retire and the board asked me to step into this role. So I've had the real privilege to take on the CEO responsibilities a little over a year ago now, and continue to work with this terrific team as we've continued to build a good team and continue to think about our longer term strategy. So lifelong industry person, water was new for me four years ago, but so much about what we do here, I'm quite familiar with from a regulatory perspective. So it's just been a real pleasure to get to know this team and this industry, and continue to think about what the future holds for American Water.

Jowell Amores (04:47):

That's fantastic, Susan, and no doubt you've been a big part of the returns that American Water has given investors over the past 10 years. And for our listeners who might not be particularly familiar with American Water in the US water utility sector, can you give us a 101 about American Water?

Susan Hardwick (05:05):

Yeah, sure. Happy to. And it's a great question. It really is, I think, an interesting story. And again, like I said, I've been in the industry forever, and frankly knew very little about the water utility sector before I joined, and that I think says a lot. I would describe it probably as one of the best kept secrets in the world of utility investment opportunities or just utility operations generally. It is a very traditional, what I would call, a very traditional regulated company. We operate in 14 regulated jurisdictions across the United States, from California all the way to New Jersey, Maryland, Pennsylvania, a lot of east coast operations. We serve, as you said, Joel, at the outset, about 14 million people through at about three and a half million direct connections. We've got 6,500 employees across our footprint. We are focused, I'd say, almost exclusively on infrastructure repair and replacement work.

(06:06):

So in layman's terms, our job is to put pipe in the ground, get a return of that investment and a return on that investment. It is the most pure regulatory story, I think, in the entire utility sector. We don't have much in the way of non-regulated companies. We have a military services group, which I'll talk a little bit about as we get into our discussion today, but it is, again, I think a very pure regulated story. So we put investment to work. We are successful in the regulatory arena because I think, again, it's a pretty straightforward story. And we've been quite successful at regulatory outcomes, both from a creative and innovative perspective as well as traditional recovery. And we've got good legislative support throughout our jurisdictions too, that give us opportunity to accelerate investment. And I just think, again, it's a big business, as I gave you a sense of the size of the business.

(07:06):

So it's large, but it's very, very straightforward. And that's one of the reasons I think that, from an investment return standpoint, we've been very steady, very predictable, very reliable in terms of what we're able to deliver back to shareholders. So that's American Water, as its place in the industry. Now, the larger perspective on the water industry I think is one again that most investors, and really honestly I would just say the general public, probably doesn't understand, about how the water infrastructure system is in the United States. There are over 50,000 water and wastewater suppliers in the country. And you contrast that to the number of electric utilities or gas utilities in the country in the forties, fifties sort of number. 52,000 people providing this service. And we are one of, call it eight, investor-owned utilities. We are the largest by probably a factor of three compared to our nearest competitor, and then it drops off significantly after that.

(08:07):

So we are far and away the largest public utility in that space. These 52,000 suppliers, as I talk about, they're in all variety of states of wellbeing, let's say. They're mostly municipal systems. They could be customer sizes of three or 400 customers to hundreds of thousands of customers. And in the smaller systems, in particular, where a municipal is charged with figuring out how to pay firemen and policemen and build parks and pave roads and maintain a water infrastructure, the challenges of that management are very, very difficult. That's why we're really focused on acquisition opportunities, part of our overall strategy. But as you think about the industry, it's so diverse and so varied in terms of state of infrastructure and quality of resources, that it makes this industry a little bit challenging to manage. That's why, again, we think we're in a great position to help facilitate that.

(09:10):

If you think about infrastructure, generally, as a country, we are on roughly a 200-year replacement cycle. Now, when I first joined American Water, four years ago, somebody told me that statistic and I said, there's got to be a decimal in the wrong place. Don't you mean 20 years? And no, the answer is 200, and American Water, we're leading the industry and we're roughly at 115 year replacement cycle. So if you think about that from two perspectives, you can say, well, gee whiz, that's a long time. It's over a century before we have this system fully refreshed, if you will. But the other side of that is from an investor standpoint, we're going to be doing this for the next 115 years, spending 3 billion a year, investing in the systems, going through the regulatory process, getting recovery and earning that roughly 10% return on that investment. So from an investor perspective, this is the best game going in terms of stability and just long term view and predictability of results.

Jowell Amores (10:13):

Yeah, no, that's a very exciting thematic, and obviously one that we're large believers in. And I think you sort of touched on a couple things here, which we'll dive into later. But before we dive into your business model and the long term strategy, let's maybe set the scene and talk about the current backdrop you're operating at the moment. So US infrastructure is in pretty ordinary shape. In fact, in the last iteration, the American Society of Civil Engineers gave the country's infrastructure an overall grade of C minus, which is, according to them, less than mediocre. Now, mediocre is arguably a generous description. So how does water and wastewater in the US stack up in all this? How mediocre is it? I note that it was given a C minus in terms of drinking water and wastewater as well. Is it really that bad?

Susan Hardwick (11:03):

Jowell, I think our answer to that would be yes. That's why we believe what we are doing here is... Sure we're an investor owned company, but we also believe that we have a significant mission here, we have a significant purpose in the drive for solutions to the problem you're describing. I was actually at a meeting yesterday with our National Association of Water Companies, and we were talking about this very issue, and we were talking about how can we get more focus on the need? And I do believe it is around awareness. I just told you I've been in the industry for 40 years, and up until four years ago, I had no idea that the infrastructure for the water and wastewater systems in this country were in the shape that they were in. It is a very tightly held secret for whatever reason.

(11:54):

And I think it is because, again, we've got 50 some thousand people trying to do this work and they're doing the best jobs they can relative to all the other priorities that they have. But at a national level, and I think even at a state regulatory level, it's just not widely understood the state of this infrastructure. So again, it's a sort of a troubling environment, but it creates a great opportunity for companies like ours, who have the size and scope and scale that we have, to be able to generate capital. We have outstanding access to capital. We can do so at reasonably low cost, we can make the investments on behalf of customers, we can improve the overall infrastructure landscape, and we can make pretty substantial progress.

(12:44):

Again, that 200 year to 115 years. It may sound like again, 115 years is untenable, but if you're talking about 200 versus one 15, you can see the sort of progress we've been able to make because of the size and scope that we have to try to address those issues. We need to address things like just state of infrastructure. We need to address things like preservation of the resource. So where is the treated water going? Another statistic I found interesting, as a country, roughly 20% of the treated water, so this is water ready for you to drink, your kids to drink. 20% of that treated water we lose before it gets to the ultimate customer.

Jowell Amores (13:25):

Yeah, that's an interesting one too. The other one I heard was that there's a water main break every two minutes, so effectively losing 6 billion gallons each day, and that's about a little under 23 billion litres per day or the equivalent of 9,000 swimming pools. So you'd think that that would be... That's a jarring statistic.

Susan Hardwick (13:44):

It is. It really is jarring. And of that 20% treated water that we're losing, main breaks are obviously a large contributor to that, but also just the pipes themselves. When we take over systems, we'll find that the pipes have deteriorated to a point where we're literally just distributing water through solidified dirt pathways or partial concrete, partial plastic, whatever, just pieces of pipes that are still in place. So of course seepage is also a big contributor. And again, you contrast that 20% to, in the electric industry line loss is what? Four, five, six percent. Gas loss, one, two percent. We're talking 20. So there's real opportunity here. And again, you just have to think about this from both sides of the equation, state of play, which is not good and needs to be addressed, and investment opportunity that a company like

American Water is really trying to push forward. And again, when you think about the simplicity, and again, I say it to our team all the time, we just put pipe in the ground and we get our money back plus a return on it. That's what we do.

Jowell Amores (14:54):

That's a pretty simple business model.

Susan Hardwick (14:56):

It is.

Jowell Amores (14:57):

I was actually talking the other day with some of your colleagues and we were talking about in certain parts of the country, they're still pulling up wooden pipes, which were in the system and somehow have fallen through the cracks. And I think it was maybe over a decade ago, I remember talking to some of your predecessors, and they'd pulled up, as in the process of replacing pipes, had even pulled up wooden pipes.

Susan Hardwick (15:21):

We actually had an example of a wooden pipe that we had recovered from a system we acquired. We showed it to our board, and our board was like, are you serious? People thought, well, we're just joking, but no, it is real. We find all sorts of things that are used to convey water to customer.

Jowell Amores (15:38):

Yeah. So there's an estimated 434 billion of investment needed, at least that's been quoted from the same engineering group, needed in water and wastewater through the end of this decade. And that's all as you had talked about, complying with regulatory requirements and safety standards as well as system hardening. And then equally important is technology and cybersecurity. So where does American Water fit in all this? Susan, can you put this into context for our listeners, investors? Can you frame the size in terms of dollar amount and the scale of the opportunity for American Water?

Susan Hardwick (16:14):

We are spending, over the next 10 years, about 32 billion. Roughly 3 billion a year. You can just do that simple math and we're roughly in that neighbourhood. We have focused more of our annual spend on, what I would call, resiliency. So we are transitioning more of our regular spend to projects that are responsive to some of the changes we're seeing, both environmentally and technologically, and customer expectations. So we're doing a lot of work where we have seen 500 or hundred-year floods happen every three or four years. We've taken treatment plants and we've moved them to higher ground, where again, geographically, you would say, based on work we've done with our civil engineering teams over the years, would say they're not in a floodplain. Well, we're seeing lots more evidence of that type of excursion. So we're taking proactive measures to put our assets in a different situation so we're not subject to those kinds of exposures.

(17:17):

We're seeing custer demand vary because of the variability in climate, and we're seeing real extremes in weather, really hot and dry, which is good for us, to really cold and wet, which is not so good from a demand standpoint. So those variations we're seeing, and that creates a lot of stress on the system. So the ability to predict and be prepared for that sort of variability is also part of our planning process. I think the thing that's challenging in this area, in terms of how we allocate capital, how much capital we put to work and how we allocate it amongst the various things we need to do, is really driven by the customer impact, frankly. If I have to think about any sort of constraint we might have, and we do this ourselves, we talk about this a lot internally, what are our limiters on how much we can spend and how quickly can we spend?

(18:14):

I'd say it really is on the customer side of the equation. We obviously don't have trouble accessing capital markets, both debt and equity, having just completed our equity raise a couple of weeks ago. So it's not capital, it's not balance sheet, it's not regulatory outcomes or legislative support. It's really none of that. It's just about the pace at which we can put this investment burden on the customer. So when you think about rates, when you think about customer impacts, our average bill for residential customer is, call it, 45 to $55 per month. Now you think about that compared to, we always use the sort of cable bill example, an average cable bill in the United States or cell phone bill might be 250, $300 a month. It's a fraction of what you're paying just to be able to use your iPhone or to watch streaming services on your television, but it does go into the larger equation for the customer.

(19:19):

They're seeing rising prices across all elements of living, inflation throughout. Electric bills are not cheap. Gas bills are not cheap. That cable bill I mentioned, not cheap. Our goal is to make sure that as we think about the customer's overall wallet share, we try to keep our piece of that wallet at roughly 1% of the total household income or lower. That's how we set our metric that helps us determine how fast and how significantly we can accelerate the spending.

(19:53):

So all of those go into that larger equation that you're asking about. How do we take in all of the changes around us, the need to speed up this investment to continue to shrink this replacement cycle? How do we think about customer's ability to pay? All of that goes into that equation and we think we've got a bit of a secret sauce here on how we balance all of those pieces, but it is a constant focus, and I don't think we'd be able to be as successful as we have been, and as confident as we are in the future if we didn't have that secret sauce figured out on how all those pieces fit together.

Jowell Amores (20:30):

A lot of our investors know and have heard about the energy transition thematic here, and I would argue that the thematic that you're on, that you're investing in, the opportunities that you have in front of you, are just as, if not even more attractive than what your electric and gas utility periods have come up with. And what we're looking at, as American Water has publicly stated out there, investors are looking forward to a long-term earnings growth rate of seven to nine percent, which is best in class. When we think about returns, and we're very risk averse at Magellan, and seven to nine percent is very attractive, particularly in this environment. Is this a case of high growth and returns equals high risk? Can you talk a bit more about the risks in and around achieving that seven to nine percent over the next five, and it sounds like it's more likely to be 10 years at this point?

Susan Hardwick (21:24):

Yeah, again, great question, and I think our real limiter there again is around how quickly can we push this to the customer. My personal belief, as I really understand this business more every day, is that the risk is actually quite low in our business, the risk of continued performance at this level. I think the growth rate that we have established is appropriate for all of the pieces that I described a few minutes ago that we try to put together. How quickly can we move, how much balance sheet capacity and/or pressure might we be under? How much customer impact can we comfortably absorb? All of those pieces together actually result in the growth rate that we've established. It's not about inherent risk in the business. There's, my view, no technological risk.

(22:21):

When you think about the electric industry, for example, lots of technological disruption there, solar, wind, the impact of electric vehicles, all those things dramatically changed that business, that came on the heels of all of the federal regulation that came from clean air and other things. We just don't face those kinds of things in our industry. So I don't think there's risk from a performance standpoint in that respect. I think really, again, our pace here is determined by getting the right equation from all those various factors. We're quite confident in our ability to continue to grow earnings at the level we've been talking about here, managed against the size of those customer impacts that again, we try to manage as we design the programme.

Jowell Amores (23:09):

Perhaps the most compelling thing is that if we are looking at seven to 9% annual earnings growth rate, if we break that down, five to 7% of that is really just the low risk blocking and tackling, as you would call it, regulated capital investment. And that's again, as you had mentioned, upgrades to systems and replacements, so very low risk stuff. And then you've got an acquisition part of your strategy which provides additional growth, but certainly the basis and the foundation of that seven to nine percent earnings growth rate is on the regulated side. So that's something that obviously we're big fans of, and again, it drives consistent and predictable returns. And perhaps if we move on to the exciting part, the one and a half to two and a half percent earnings growth that's coming from acquisitions, I know it's a small part, but we find this acquisition strategy both fascinating and exciting. Tell us why investors should be as excited as we are in terms of this M&A strategy.

Susan Hardwick (24:09):

Well, I think you're right to be excited about it. We certainly are too. And again, go back to some of my comments at the very beginning. There are 52,000 potential acquisition opportunities. We know literally the acquisition population here, and we think that it's part of our mission, our obligation, our placement in the industry to continue to focus on acquiring these municipal systems that are struggling to provide quality water and wastewater services to customers. We're not just trying to put people out of business for the sake of it, we're actually trying to help these communities put themselves in a better position than they have been in. We have the expertise, the capital, et cetera, where a lot of times these communities don't have. So we are solving problems that they have. Communities may come to us and say, we think we're doing okay with the water system, but man, we've got underfunded pension plans.

(25:11):

We've got a need to fix roads and do all these other things in our community, and we don't have the capital to do it. The water utility happens to be, in their view, pretty good shape. So if we monetize that, that frees up then a lot of capital for those communities to be able to do their other priorities. That's a reason that communities come to us. Just the state of the water and wastewater systems themselves of course is another driver why people come to us and say, Hey, just one too many regulations, we can't do it anymore. We just don't have the resources to be able to manage the system, so we need you to take over and help us. There's a whole variety of reasons, and I'm sure you've seen the EPA just put out this proposed rule on these forever chemicals [inaudible 00:25:55] So we're still evaluating that, but that's certainly another area where communities are saying it's beyond us.

(26:01):

It's too hard for us to figure out how to deal with that. So great opportunity, lots of drivers for these communities to say we're ready to sell. The challenging part in this acquisition strategy is take that same community, small community, say, thousand customers, 2000 customers, whatever, small town run by a city council, run by a mayor, all elected officials, mayor responsible for a whole bunch of stuff. The water system becomes oftentimes a very political issue for those mayors. Water's personal to people. So when the mayor starts talking about, Hey, I'm going to sell this system, people get worked up about it. And so navigating that local process to secure that community and pick up those 2000 customers is often a very time-consuming process, frustrating. Sometimes you think you're right at the finish line and suddenly the mayor decides he doesn't want to run for reelection, and now you're back to square one.

(27:05):

There's all sorts of things that make this acquisition arena, as you would say, very exciting. But again, there's 52,000 opportunities to do this, and we have a very experienced and widely distributed business development team out in our jurisdictions that have those relationships, know those mayors, know those city council members, and are spending time in those local communities to develop those relationships, and make the case for why now is the time to sell your system to American Water. So it's a lengthy process. It's a boots on the ground process that obviously pays great benefits. Once we have acquired a system, it becomes then the five to seven percent on that triangle. They become now part of sort of the base capital, the base investment, and we'll just continue to grow those systems like we do our own. Oftentimes we buy these systems for a price. I'll talk a little bit about the process on that, but once we get them, we'll know, based on our due diligence, that there's a lot of follow on capital opportunities.

(28:13):

So we may pay say 50 million for a system knowing that there's another a hundred million to spend once we buy the system. So automatically there's 150 million dollars of rate base that we can put to work right away. So that's all part of the equation. We have worked hard in all of our jurisdictions to get supportive legislation that makes the acquisition process work pretty effectively. And one of those tools is what we call fair market value. So we have legislation in many states that says, that actually encourages this privatisation, encourages communities to sell to a company like us, because it guarantees the value they get in a sale, and it guarantees us recovery of the purchase price.

(28:58):

So we don't incur a bunch of goodwill, we don't load up the balance sheet with unrecovered assets. We all know going in what is the real value of the system and what we'll get in terms of rate recovery. So that facilitates a lot. And again, it works on both sides. The community, they don't have to be expert negotiators. We do appraisals when we let that process determine the fair value of the system, so the city gets what they are entitled to, and then we get certainty around recovery of the investment. So, very important part of the process.

Jowell Amores (29:30):

So is it just purely on price that gets municipalities across the line as well as regulators, or is there more than that to convince them to sell to you?

Susan Hardwick (29:40):

Yeah, you really have to address what their real need is. In some circumstances it is about finances. It is about securing a purchase price that solves a particular problem for them. But in other situations, it's less about the price and more about just quality of life. It's more about other community initiatives that they want to advance versus managing or maintaining a water system. And that's one of the things that's so important about this strategy for us, is to have those business development folks in the communities, on the ground, understanding what that community's specific need is so we can design a transaction that works best for them. It's not a one size fits all. It's not like you typically think about normal investor owned M&A, it's a different animal altogether, which is great, but also makes it a bit more complicated.

Jowell Amores (30:36):

And where's American Water's competitive advantage in all this, in terms of the acquisition strategy?

Susan Hardwick (30:42):

I think it is our size and scale. We have a lot of examples to be able to share with communities. We have a lot of track record here in terms of making communities a dramatically different place to live and work than they were before. And we use testimonials a lot. We do a lot of work where we'll acquire one system and then we suddenly then get lots of interest in the communities all adjacent to the one we acquired, because we leverage that experience with these other communities. So it is really just our size and our footprint that allows us to be successful in this arena. I can't emphasise enough how local this acquisition business is.

(31:28):

If I'm sitting in Camden, New Jersey, in our headquarters today, if I sent my chief growth officer to some small town in Illinois to knock on a door, they would say, who are you? What we need to do is send our local operating people in Illinois and our business development team in Illinois and say, Hey, Sally or Joe, when I see you at the community potluck on Friday night, let's talk about the water system. That's how it gets done. It's a really interesting model. And I came from a world again where big M&A was just part of our DNA. It's a different animal here, and we've been quite successful at it.

Jowell Amores (32:07):

No, and you have, and one thing we admire is the fact that it's not one, the acquisition strategies is, for the lack of a better term, it's a small but many. So one deal's not going to make or break any given year. It's a number of small ones.

Susan Hardwick (32:23):

For example, Jowell, not to interrupt you, but in 2022 we did 26 acquisitions. We closed 26 deals and spent 300, call it 350 million dollars. That tells you right there the size of these. And so it takes a lot to add up to the kind of numbers we're talking about, and it's a lot of legwork and a lot of long hours and a lot of disappointment. But we also have a lot of success, and that's why it's important to have a team that understands how this works, and we just keep plugging away at opportunities.

Jowell Amores (32:56):

And the best part I think is that it feeds into that five to seven percent growth component of your overall earnings growth rate-

Susan Hardwick (33:04):

Absolutely.

Jowell Amores (33:04):

A flywheel effect. Not to steal some terminology, but very much so.

Susan Hardwick (33:10):

That's exactly right. It's not a sort of one and done. It does feed the base of our growth triangle. Yeah.

Jowell Amores (33:18):

And it probably explains why you've compounded in terms of the total shareholder returns, why we've seen such incredible compounding for investors. Now, maybe if we take a slight turn here, Susan, now thinking as an investor, what would **Susan Hardwick** be telling investors to look for in a utility? Obviously, if you're heading up American Water and you've been in the electric utility space, what questions would you be asking a utility CEO?

Susan Hardwick (33:47):

I am biassed. I'll just admit that right at the outset. I have been in this industry for a long time. I think this is a special industry, and I'm talking about the utility sector generally. I've always believed that the work we do as utility employees is a very special kind of work. And I think that's even more so when I think about the water sector and the impact that the work we're doing, whether it be through an acquisition or through just base investment here, is a real privilege, and our team start to finish takes that responsibility quite seriously. Now, what's that have to do with an investor's perspective? I think sort of understanding the culture of the industry and the mission driven nature of the industry is important to investors because we are committed to this strategy. We are committed to the long term delivery of the work that we do here, both investment and operating service.

(34:48):

So when I think about, in that context, so understanding the business, understanding the culture of the business and the culture of the industry, then I start to think about how can I just put my investment on autopilot and let it just do its thing? And again, I think the utility industry at large is a good vehicle for that, particularly in the environment that we're in, obviously, with so much volatility, so much unpredictability through all sectors. The utility sector, even though we ride up and down a little bit on some of the macro issues, generally speaking, the utility industry has always kept its head about it and performed well.

(35:31):

Now, if I differentiate American Water from the rest of the sector, I think it is about what does the underlying business really do? And the underlying business, we put pipe in the ground, we get recovery, of and on. That's all we do. And so when you're thinking about predictability, reliability of returns, reliability of delivery on the proposition, which is consistent earnings growth, strong dividend with a good dividend growth track record, there's no better story than American Water. And I'm not just saying that because I'm the CEO, I know it factually. There is no better story. There is no better opportunity than American Water. If you want reliable, predictable, sustainable for the long term investment returns, there's no better place to look than here.

Jowell Amores (36:25):

Those are the most beautiful words I've heard this financial year, Susan. Keep it up.

Susan Hardwick (36:30):

It's the truth. We believe it. We believe it.

Jowell Amores ([36:32](#)):

Now, has the value proposition changed over the past decade? We talk about the incredible returns you've delivered for shareholders over the last 10 years. What should shareholders expect from American Water, from AWK shares over the next five to 10? More of the same?

Susan Hardwick ([36:48](#)):

Absolutely more of the same. Now, I can't sit here and tell you that we're going to go... I don't know what we closed at today, but we're going to go from 138 bucks a share to 200 bucks a share. I'm not going to make those kind of predictions because there's so much of that macro backdrop that affects the absolute values here. But you can count on the fact that we will continue to deliver this quality of service. We will continue to deliver on our mission, which is to improve the state of infrastructure in this country, to continue to focus on opportunities to deliver quality water, water and wastewater services to more and more people, and will do so in a very responsible way, environmentally, all of the things that sort of go with the word responsible, including financial responsibility. We've got an excellent balance sheet. We've just improved the quality of this balance sheet with this equity issue we just did a couple of weeks ago.

([37:47](#)):

We'll continue to be focused on that secret sauce I talked about, the combination of how fast to spend, how to finance it, and how does it impact the customer. That will continue to be our focus. And as we do that, I'm confident we can continue to deliver at the pace we've been delivering. And again, do so predictably, reliably. If we get off track on that is when I think people should start to worry. But I can tell you that our full team, again, from our youngest associate to our most senior person, that is the drive, that is the mission. That's how we think about doing this work every single day. And again, it helps, Jowell, and I'll just be again completely honest with you, it helps that this business is pretty simple. It is big, but it's pretty simple, and that helps keep people focused. We're not distracting people with a lot of ancillary businesses, a lot of risk appetite that's beyond what is the basic business here. And I think that matters a lot, particularly in this environment.

Jowell Amores ([38:48](#)):

Now, our discussion wouldn't be incomplete if we didn't talk about the risks for the utility. And those have evolved too. So over the near term we're dealing with, I imagine, with inflation and interest rates. Can you briefly touch upon that, as well as some of the other larger risks at play? Obviously regulatory, but more so cybersecurity. You're responsible for a very important piece of infrastructure. Can you talk around some of these risks for the business?

Susan Hardwick ([39:15](#)):

Yeah, and you've hit on all the key categories. When you think about this macro stuff I've been talking about, inflation, interest rates, et cetera, obviously big impacts to any organisation and certainly we're not immune from that. We're the largest buyer of pipe in the country. Our three largest costs are chemicals, power and labour. So chemicals and power, obviously very much subject to these inflationary impacts. We've done a wonderful job, in my opinion, managing through that through our supply chain. The supply chain has done a wonderful job of renegotiating contracts, working with suppliers to make sure we have access to supplies at reasonable prices. And we've also been very successful in the regulatory arena, making sure that we get recovery of those costs. But that's really the issue. All of these costs eventually make their way to the customer's bill. So that's the difficult part of this environment that we're in.

([40:16](#)):

How do you manage all of those inflationary impacts along with the need to spend the capital and the need to make the investment at a rapid pace? So that's the challenge around that particular part. You mentioned cybersecurity, I think it's an interesting topic and it's obviously one we spend a lot of time on. We're actually working directly with the White House and the various task force on cybersecurity to address larger concerns around infrastructure. The weird thing about the water sector though, unlike the electric grid as an example, it's not integrated. So when you think about the opportunity that cyber threats have on the electric system to do some sort of attack, and essentially wipe out a significant part of the country, or even all of the electric grid, it's not possible in the water sector. So that's a mitigating factor. I know that sounds weird, but it is a mitigating factor. Because our systems are so poorly connected, it's difficult to disrupt a large section of the population.

(41:25):

Now what can happen, and we've seen a bit of this in, not American Water territory, but in the water industry, we've seen a few examples where bad actors have hacked into our water treatment plants, not ours, again, but a water treatment plant, and hacked into the control system and changed the mix of chemicals going into the treatment plant. Now in this particular case, it was detected, human detection before it affected any of the end users. But that's the risk, I think, in our sector, it's not that they're taking out a large section of the population, but they're able to potentially hack into a system that could do bodily harm to people through the treatment process. We've got controls around all of that, and we've got a very robust cybersecurity team. And like I said, the head of our cyber team here leads a number of national efforts around cybersecurity in the water space.

(42:25):

So we feel like we're in good shape and a great place to work through those issues. But they are real, and I just think they're probably less of a threat for us than perhaps other sectors of the utility space simply because, again, the way the systems are constructed. So again, I think when you summarise all of that, cyber, I think, is that issue. But when you summarise sort of the rest of the risks around the business, inflation, interest rates, et cetera, the difficult part there is what impact it has on the customer. These costs do eventually find their way into the customer's bill, and we have to just manage around that issue. And to date, because of our size and scope, we have not had any impacts to our overall capital plan as a result of these impacts. And when I say that, I mean specifically have we had to scale back our investment plan because of other cost increases that ultimately pass on to the customer. And we've not had to do that. We've been able to sort of manage through it with all of our various tools.

Jowell Amores (43:27):

And Susan, perhaps lastly, what did you learn as a CEO during the pandemic and then coming out of it as a business, as a person?

Susan Hardwick (43:35):

Well, Jowell, that could be a whole separate podcast. Okay, I'm going to make this a quick answer. I learned two things. I learned that employees in the water sector, utility sector generally, but in the water sector specifically, are remarkable people. And that we did not miss a beat as it relates to providing service to our customers. I knew that would be the case, but until you actually test yourselves, like the pandemic did, you don't really know. We did not miss a beat. Our frontline employees, we've got over 4,000 frontline employees, never missed a day of work, never missed a beat, never missed a single customer exposure. Now we put all kind of safety protocols in place, of course. We did lots to protect our team as well as the public. But the ability to just continue doing what we do... If you remember, and I'm sure you do, in the beginning days of this pandemic, it was scary. We didn't really know whether or not people would survive it. So it's pretty scary sitting here.

(44:42):

I was the CFO at the time at the start of the pandemic, and then of course, CEO at the end, sending our people out to do this work in that environment. It's a very scary thing to do. So I learned that our people are remarkable. I also learned that we can actually do the work, not the frontline folks, but the support folks. We can do that work in a variety of ways. So I know there's always a lot of discussion about flexible work environment, all those kinds of things. I learned that we're pretty adaptable people, and we can get a lot done in a variety of settings, in a variety of ways. And I think there's a lot of advantage to that. I worry about do we lose the development opportunity that you get from sitting in the office next to somebody? And I think we'll see over time how significant that impact is, but by and large, we've not missed a beat at that level either, and we've done so in a very flexible environment.

Jowell Amores (45:39):

Fantastic. Well, thank you, Susan, for joining us today. It's been an honour to have you on. This has been fantastic and in very insightful, and hopefully our listeners have come to better appreciate the role of American Water in our fund and why it's been one of our longest held positions in the strategy.

Susan Hardwick (45:56):

Well, thank you, Jowell. We certainly appreciate the opportunity to speak with your investors today, and it's just been a real privilege for me to have time with you here today. So anything we can do to continue the conversation, we're happy to do.

Jowell Amores (46:09):

Thanks again, Susan.

Susan Hardwick (46:10):

All right, thank you.

Host (46:11):

That was Magellan head of Macro and portfolio manager, Jowell Amores, speaking with American Waterworks President and CEO Susan Hardwick. We trust you've enjoyed this episode of Magellan In the Know. Join us in a month's time for the next episode. For more information on upcoming episodes, visit magellangroup.com.au/podcast, where you can also sign up to receive our regular investment insights programme. Thanks for listening.