

Aqua America, Inc. (WTR)

Analyst Day Highlights

Price: (10/1/09)	17.53	Rating:	Outperform	FY Dec	2008A	2009E	2010E
52WK H-L:	22 - 12			Q1	0.11A	0.14A	
Market Cap (mil):	2,371.81	Suitability:	Lower Risk	Q2	0.17A	0.19A	
Shares Out (mil):	135.3			Q3	0.26A	0.22E	
Float (mil):	134.7			Q4	0.19A	0.23E	
Avg. Daily Vol (mil):	0.68			Total	0.73A	0.78E	0.92E
Dividend:	0.54	Price Target:	22	Previous		0.84E	
Yield:	3.08			FY P/E	24.0	22.5	19.1

Please refer to Appendix - Important Disclosures and Analyst Certification.

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Action

Maintain Outperform rating. We continue to believe that WTR's acquisition strategy and stable EPS growth will fuel above-average total returns. WTR's regulatory environment continues to improve, reflecting rate relief and regulatory division consolidation potentially providing upside for 2010 EPS. The abnormally wet summer weather is expected to pressure 3Q09 more significantly than previously expected leading to a reduction of our 2009 estimate.

Summary

- On 9/29, WTR hosted its analyst day in New York. Key take aways from the presentation include:
 - **3Q09 results expected to be negatively impacted** by \$0.03 YOY due to abnormally wet weather.
 - With the wettest summer in PA in 88 years, sales are expected to be negatively impacted by approximately 7-8%.
 - Higher pension expense expected to boost O&M YOY.
 - **Continued focus on acquisitions and capital investments.**
 - Mid-sized municipals are primary acquisition targets.
 - Major focus on underground pipeline renewal and replacement.
 - o Majority of capex is discretionary with less than 10% for mandatory compliance projects.
 - **Regulatory environment continues to improve.**
 - Regulatory lag time has pressured EPS growth.
 - Increased frequency and smaller rate cases are expected to be the norm in the future.
 - Consolidation of rate divisions is ongoing to mitigate differences in earned vs. authorized returns and smooth rate increases for payers.
 - Pension expense expected to be recovered in future rates.
 - **Cash flow will be positively affected by federal stimulus** through low interest loans, bonus tax depreciation benefits, and non-AMT tax exempt bonds.
- **Reducing 2009 estimate** to \$0.78 from \$0.84 due to unfavorable summer weather in 3Q09. Weather swings are normal from year to year and due to the constructive regulatory environment and continued acquisitions strategy, **we maintain our \$22 price target and Outperform rating.**

Details

Acquisitions

WTR continues its successful acquisition strategy. WTR has acquired 23 US-based, regulated water and wastewater systems since 7/1/08 which has increased efficiency by filling in its US footprint.

Primary targets are mid-sized municipals with the possibility of being platform builders which can provide higher customer density and economies of scale.

- Acquisition target scope
 - 47,000 small systems serving < 3,300 people (Total potential: 28 million people)
 - 4,300 medium systems serving < 10,000 people (Total 28 million people)
 - 2,500 large systems serving > 10,000 people (Total 121 million people)

Regulatory Environment

WTR continues to seek to improve its regulatory strategy in all operations to minimize regulatory lag through more frequent and smaller requested increases, rate division consolidation to reduce rate differences, and requesting infrastructure surcharges and cost pass-throughs.

Rate Division Consolidation

- **North Carolina:** Rate cases have been completed by 4/2009 which will provide an additional \$7.7 million in additional revenue. 23 rate divisions were consolidated to 4.
 - Additional rate case filings are expected over the next two years.
- **Florida:** Rate cases have been completed by 4/2009 resulting in additional \$5.5 million in revenue. 82 rate divisions were consolidated into 8.
 - Additional rate case filings are expected over the next two years.
- **Virginia:** Consolidated rate case is in the filing process requesting consolidation of 21 rate divisions to 2.
- **Pennsylvania Wastewater:** The rest of PA water system's rate divisions have been in 1 regulatory division for many years, but a consolidated rate case filing is in progress for the wastewater system requesting consolidation of 7 rate divisions to 1.

Pension Expense

WTR is initiating recovery of pension expense in rates. The majority of book expense is in PA where rates are set using ERISA contribution level, allowing for low regulatory lag risk. However, regulatory lag in the Northern states exists with \$1.2 million in 2008 pension expense not recovered due to rates not being set using ERISA contribution level. A fairly significant increase is expected in 2009 from the 2008 level. WTR is currently working on initiating recovery of Northern states' pension expense in future rates. Additionally, any new hires from 2003 onwards have not been offered a defined benefit pension plan, effectively reducing future pension expense by instead offering a defined contribution plan with matching employee contribution based on a percentage of participants' compensation.

Cash Flow

Cash flow positively impacted by federal stimulus act and reduced regulatory lag. The stimulus act has contributed to positive cash flow through bonus tax depreciation benefits (2008: \$30 million; 2009: \$38 million), low interest SRLF loans (2009 funding: \$7.3 million with approved additional \$7.7 million), and tax-exempt bonds now Non-AMT (July 2009: issued \$58 million; 4Q09 approved amount: \$75 million for water delivery infrastructure improvements). Rate relief and modified regulatory practices have contributed to Southern States' division cash flow switching from negative over the last 3 years to positive \$10 million as of YTD 2009.

Investment Thesis

We rate Aqua America (WTR) Outperform with a 12-month price target of \$22. Our price target is 22x our 2011 EPS estimate, we believe in line with its peers when fully valued due to its relative earnings consistency, longer-term growth opportunities and wider potential shareholder base reflecting its relative size and liquidity. Key investment considerations include the following:

- **Strong leadership team.** We believe Aqua has a strong leadership team that has demonstrated a keen focus on developing strong regulatory relationships and engineering innovative solutions to improve water system quality while providing investors with appropriate recovery, such as the DSIC mechanism first established in Pennsylvania. We believe management has executed regulatory and investment plans that have caused stable and consistent value creation for investors.
- **Attractive total return potential.** We expect 4-6% long-term annual EPS growth with a 60-70% dividend payout ratio, providing a current dividend yield of 3%. We believe growth could accelerate beyond this level if WTR is able to accelerate its acquisition program of water and wastewater systems.
- **Constructive regulatory mechanisms.** The majority of WTR's regulatory operations are located in states that maintain enhanced regulatory recovery mechanisms that enable stable earned returns, including infrastructure investment riders, statewide rates and incentive mechanisms for acquisitions of troubled water systems. We believe such mechanisms provide a constructive regulatory environment in which to make capital investments, enabling improved and more consistent earned returns, which should lead to a premium peer valuation.
- **Acquisition growth.** Aqua has successfully acquired hundreds of water and wastewater systems in the past decade to supplement its internal growth, which also provides significant follow-on investment opportunities as it improves the quality of the acquired water system. We believe such acquisitions are a key value driver for the company and the stock, as it continues to be a key player in consolidating some of the 53,000 water systems outstanding in the U.S. and rehabilitating those systems to improve water quality and drive investment growth.
- **Investment shifting to pipe replacement.** Following significant advancements in water quality standards that necessitated major water project investments into water treatment systems, Aqua's investment mix is shifting toward pipe replacement as its system quality has generally met the more stringent EPA water quality standards. While substantial capital investments will still be required to fund pipe replacement, the level of rate base growth could decline versus historical levels.
- **Water utility valuation.** We expect solid earned ROEs, 5-8% longer-term EPS growth potential and constructive regulatory investment recovery mechanisms should support an 20-22x forward P/E. The valuation is a premium to its regulated electric and gas utility peers reflecting significant industry consolidation and rate base growth opportunities with lowered regulatory risk, and generally more constructive regulatory mechanisms that enable earnings consistency.

Risks & Caveats

Our suitability rating on Aqua America is Lower Risk. Key risks include, but are not limited to, the following:

- **Regulation.** Regulated operations are subject to local, state and federal regulations. Changes in the regulatory environment can affect WTR's near-term and long-term performance.
- **Weather.** WTR's businesses are sensitive to fluctuations in the weather. Particularly wet or dry weather can impact near-term financial results.

- **Acquisition risk.** WTR may have the opportunity to purchase assets or companies in the near future. Acquisitions carry risks related to personnel, expected-versus-actual growth and a myriad of unforeseen hurdles, all of which can negatively affect earnings.
- **Product quality.** Unique among its sister regulated utility sectors, water utilities provide a product that is ingested. Despite robust mandated service quality standards that lower risk, a quality failure could materially impact the earnings and stock of WTR.
- **Dividend legislation.** Congress has extended tax legislation that reduced the tax rate on dividends received. However, the extensions only last through 2009 and there can be no assurance that further extensions of the tax relief will occur or that a future Congress would not repeal the current legislation, which could have an adverse impact on the after-tax value of dividends and the stock.

Company Description

Aqua America is a holding company for numerous regulated water and wastewater utilities operating in the eastern half of the U.S. that serve over 2.8 million people. It is the second-largest investor-owned water utility in the U.S. Known as Philadelphia Suburban Corporation until 2004, Aqua America is headquartered in the Philadelphia suburbs where its corporate roots date back to 1886 for providing water and/or wastewater service to the suburbs west and north of Philadelphia.

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Aqua America, Inc.

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