

Aqua America (WTR - \$19.87 - NYSE)

Back on Track - Buy

<u>Year</u>	<u>EPS</u>	<u>P/E</u>	<u>PMV</u>	
2012P	\$1.10	18.0x	\$29	Dividend: \$0.62(a) Current Return: 3.1%
2011P	1.00	19.9	27	Shares O/S: 136.8 million
2010E	0.88	22.7	25	52-Week Range: \$20.08 - \$15.39
2009A	0.77	25.9	-	

(a)Increased to \$0.62 for holders of record 11/17/2010.

SUMMARY AND OPINION

Aqua America is a national water utility serving roughly three million residents in thirteen states in the eastern half of the United States. Roughly 55% of earnings are derived from Aqua Pennsylvania, but Aqua subsidiaries also serve customers in Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Florida, Indiana, Virginia, Maine, Missouri, and South Carolina.

- On August 3, 2010, Aqua America reported second quarter earnings of \$0.22 per share, which represents a 16% increase over the \$0.19 per share earned for the similar period in 2009. Revenues increased 6.6% to \$178.4 million and net income increased 16% to \$29.9 million while operating and maintenance expense rose a modest 1.1%. First half 2010 earnings were \$0.38 per share, which represents a 15% increase over the \$0.33 per share earned over the same period last year.
- The 6.6% increase in second quarter revenue was driven by a 3.4% increase in rates (including 1.5% from distribution surcharges), 1% from organic growth (acquisitions and normal customer growth) and 2.2% from higher, weather-related consumption vs. last year's abnormally wet quarter.
- Through the first six-months of 2010, WTR subsidiaries implemented annual rate increases totaling \$43.7 million and requested \$13.7 million in higher annual revenues where decisions are expected by year-end. In addition, WTR plans to file for an additional \$28.5 million in higher annual revenues by year-end 2010. WTR has completed 12 acquisitions year-to-date and expects to complete 20 to 30 for the full year.

Table 1

(\$ millions, except per share data)	Aqua America					
	Second Quarter			First Half		
	2009	2010	% Change	2009	2010	% Change
Operating Revenues	\$167.3	\$178.4	6.6%	\$321.8	\$339.0	5.3%
O&M Expense	68.5	69.3	1.1	135.5	136.9	1.0
O&M/Revenue Ratio	41.0%	38.8%	(5.2)	42.1%	40.4%	(4.1)
Operating Income	\$58.9	\$66.1	12.3	\$105.6	\$116.8	10.6
EPS	\$0.19	\$0.22	15.8	\$0.33	\$0.38	15.2

Source: Company data

- We regard WTR as a well-managed, low-risk, high quality conservative utility with unique growth opportunities. As the second-largest regulated water utility in the nation, WTRs national presence, diverse geographic footprint, technical expertise, operating reputation and financial resources favorably position it to consolidate the fragmented water industry. Over the past 15 years, the company has completed more than 235 growth ventures, and tripled its customer base.

Back on Track For 8-10% EPS Growth

Our 2010 and 2011 earnings estimates remain \$0.88 and \$1.00, respectively, per share. We expect a strong second half 2010 when compared to the \$0.45 per share earned in the second half of 2009. Earnings growth will be driven by more favorable weather, rate relief, including large revenue increases in Pennsylvania (\$24 million) and New Jersey (\$4 million) in mid 2010, the acquisition of smaller systems, and continued cost control. July weather has been considerably more favorable than last year's abnormally wet weather.

Longer term, we expect annual earnings growth to return to WTR's historic target rate of 8-10% per share driven by ongoing rate relief, improved profit levels in the Southern region, customer growth and increased operational efficiency. We expect continued rate relief and efficiency improvement at underperforming systems in Florida and North Carolina. The company acquired these troubled southern systems in 2004 and 2005 and has spent several years working to improve operational performance and earned returns. We expect the low earned returns in the Florida and Carolina jurisdictions to improve to normal 10% levels by 2012.

WTR has completed twelve acquisitions of water or wastewater systems this year and management believes there is currently an uptick in deal activity and hopes to achieve its long term target of 20-30 acquisitions per year, up from 18 in 2009. Acquisitions added roughly 0.5% to customer growth in 2009 and are expected to add closer to 0.75% in 2010. We expect WTR to spend roughly \$20-30 million per annum on acquisitions of smaller systems and will periodically acquire larger more strategic assets. The recession slowed normal organic customer growth to below 1%, from historic 1-2% levels. However, we expect a recovering economy will lead to recovery in customer growth, particularly in the Florida, Carolina and Texas areas.

Table 2 Aqua America Private Market Value Analysis, 2005A-2013P

(\$ in millions, except per share data)

	2005A	2006A	2007A	2008A	2009A	2010E	2011P	2012P	2013P
Utility Revenue	\$496.8	\$533.5	\$602.5	\$627.0	\$670.5	\$686.5	\$711.4	\$737.2	\$764.1
Utility EBITDA	260.9	281.6	305.6	319.9	355.7	395.6	436.2	466.6	500.8
Book Value	811.9	921.6	976.3	1,058.4	1,108.9	1,154.0	1,215.2	1,346.3	1,425.7
Multiple	2.5	2.5	2.5	2.5	3.0	3.0	3.0	3.0	3.0
Value of regulated utilities	\$2,029.8	\$2,304.1	\$2,440.7	\$2,646.1	\$3,326.7	\$3,462.0	\$3,645.6	\$4,038.8	\$4,277.2
Less: Net Options Payments (1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Private Market Value	\$2,029.8	\$2,304.1	\$2,440.7	\$2,646.1	\$3,326.7	\$3,462.0	\$3,645.6	\$4,038.8	\$4,276.2
Shares outstanding	129.2	131.8	133.6	134.7	136.1	136.8	137.4	139.5	141.5
PMV per share	\$16	\$17	\$18	\$20	\$24	\$25	\$27	\$29	\$30
Discount to PMV	-26%	-14%	-9%	-1%	19%	21%	25%	31%	34%
EPS	\$0.71	\$0.70	\$0.71	\$0.73	\$0.77	\$0.88	\$1.00	\$1.10	\$1.20
P/E	28.2	28.5	27.9	27.3	25.9	22.7	19.9	18.0	16.6
Year End Book Value	\$6.26	\$6.93	\$7.28	\$7.82	\$8.12	\$8.42	\$8.82	\$9.53	\$10.05
P/B	317%	287%	273%	254%	245%	236%	225%	208%	198%
ROE	11.7%	10.6%	10.0%	9.6%	9.6%	10.6%	11.6%	12.0%	12.2%

Source: Company data and Gabelli & Company, Inc. estimates

(1) Payments to buy out options holders at PMV, net of taxes.

Immediate Returns on Pipe Replacement

We expect earnings growth to increasingly benefit from growing recognition of automatic rate adjustments for certain infrastructure investment. In 2009, the Pennsylvania Public Utility Commission authorized Aqua Pennsylvania, WTR's largest subsidiary, to increase its Distribution Improvement Surcharge (DSIC) to 7.5%, from 5%. The DSIC is a quarterly surcharge applied to customer bills to recognize (including return on) investment in pipe replacement and/or refurbishment. As a result, Aqua Pennsylvania can implement up to a 7.5% revenue increase before filing for a general rate case. The mechanism is designed to encourage the state's water utilities to invest in the water distribution system, which had been neglected for decades. States with similar infrastructure surcharge mechanisms include Missouri, Indiana, Illinois, Ohio, and New York. Connecticut and Delaware also have pipe investment mechanisms.

Continued Efficiency Gains

WTR continues to be among the more efficient water utilities in the nation. The first-half 2010 O&M/Revenue ratio was 40.4% compared with 42.1% for the same period last year. In 2009, the O&M/Revenue ratio declined to 40.3%, from 41.8% in 2008. The improving ratio is a function of continued efficiency gains from the company's southern region water systems, which were acquired in 2004 and 2005, as well as a modest acceleration of revenue growth related to an improving economy, more normal weather and higher rates. We expect this trend to continue.

Second Quarter EPS Rise 16%

On August 3, 2010, Aqua America reported second quarter earnings of \$0.22 per share compared to \$0.19 per share for the similar period in 2009. Revenues increased 6.6% to \$178.4 million; net income increased 16% to \$29.9 million while operating and maintenance expense rose a modest 1.1%.

The 6.6% increase in revenue was driven by a 3.4% increase in rates (including 1.5% from distribution surcharges), 1% from organic growth (acquisitions and normal customer growth) and 2.2% from higher consumption related to a return to more normal weather. The company's service territories experienced wet April and May weather, but more normal June weather versus last year's abnormally mild and wet second quarter.

Capital Expenditure Budget

Management invested roughly \$141 million of its planned 2010 budget of \$300 million through the first six-months. Given that roughly 60-70% of capital investments are distribution-related, we view the nearly immediate earnings recovery that WTR receives on these investments as a favorable one. The five-year capital budget is currently estimated at \$1.5 billion, including \$20-30 million from acquisitions.

We expect internally-generated funding to cover roughly 85% of the company's 2010 capital spending budget with any equity needs accomplished via internal programs. WTR has ample access to capital as evidenced by its balance sheet (42.2% common equity), A+ rated senior corporate debt and historical valuation multiples ranging between 200-375% of book value. WTR boasts among the highest credit ratings of any publicly-traded utility and its overall embedded cost of debt is among the lowest.

Dividend Policy

On August 3, 2010, the WTR Board raised the annual dividend by \$0.04, or 6.9%, to \$0.62 from \$0.58, which represents the twentieth time in the last 19 years that the dividend has been increased. The \$0.62 annual rate represents 66% of our 2010 EPS estimate of \$0.88.

Valuation

WTR shares currently trade at 22.7X and 19.9X our 2010 and 2011 earnings estimates and 240% of book value, which compares to group multiples of 20.3X and 18.0X and 185% of book value. Over the past ten years, WTR shares have traded between 15-35X forward earnings and significant premium multiples to the group. Our estimated 2010 private market value estimate is \$25 per share.

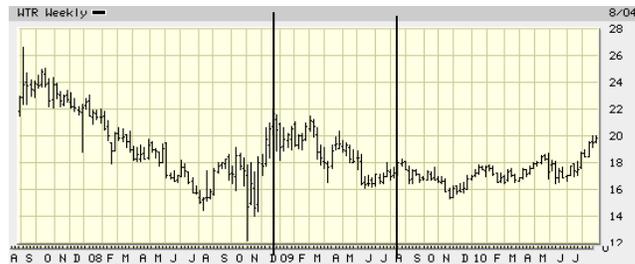
We believe that the Private Market Value of WTR is around \$25-27 per share, at a premium of 300-325% to book value, which compares to 250-325% premiums in the last ten takeover agreements, including the recent announcement that Southwest Water (SWWC) has agreed to be purchased at 268% of tangible book value by a private equity infrastructure group. We believe WTR shares warrant premium multiples given the company's national presence, strong financial condition, strong reputation, strong EPS outlook and successful track record.

Primary Risks to our recommendation include regulatory risk (poor rate decision), an acquisition announcement at a premium multiple, potential retirement of the CEO, higher interest rates, and market risk.

Other Companies Mentioned:

Southwest Water Co. (SWWC – NASDAQ)

**Aqua America
Price Performance Since Initial Recommendation**



Source: Public Data. On December 2, 2008 we placed a HOLD on WTR at a price of \$18.92 and on August 7, 2009 we placed a BUY at a price of \$16.97.

We, **Tim Winter, CFA, and Jose Garza** the Research Analysts who prepared this report, hereby certify that the views expressed in this report accurately reflect the analyst's personal views about the subject companies and their securities. The Research Analysts have not been, are not and will not be receiving direct or indirect compensation for expressing the specific recommendation or view in this report.

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Important Disclosures

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Analysts' ratings are largely (but not always) determined by our "private market value," or PMV methodology. Our basic goal is to understand in absolute terms what a rational, strategic buyer would pay for an asset in an open, arms-length transaction. At the same time, analysts also look for underlying catalysts that could encourage those private market values to surface.

A **Buy** rated stock is one that in our view is trading at a meaningful discount to our estimated PMV. We could expect a more modest private market value to increase at an accelerated pace, the discount of the public stock price to PMV to narrow through the emergence of a catalyst, or some combination of the two to occur.

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