

Water

Aqua America, Inc.

(WTR) - BUY

Price: \$17.49
 Fair Value Estimate: \$20.00
 52-Week Range: \$20.37-\$15.39
 Market Cap (MM): \$2,354
 Shr.O/S-Diluted (mm): 136.3
 Average Daily Volume: 989,038
 Dividend: \$0.58
 Yield: 3.4%

FYE: Dec	2009A	2010E	2011E
EPS:	\$0.77	\$0.85	\$0.95
Prior EPS:		\$0.89	NC
P/E Ratio:	22.7x	20.6x	18.4x

Quarterly EPS:

Quarter	2009	2010	2011
Q1	\$0.14	\$0.15	--
Q2	\$0.19	\$0.20	--
Q3	\$0.25	\$0.28	--
Q4	\$0.20	\$0.22	--

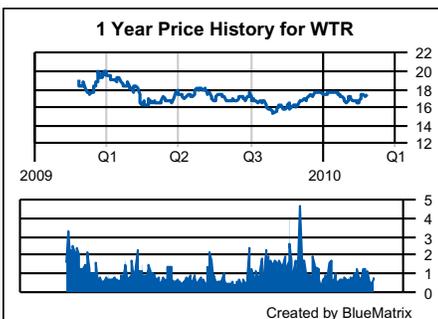
Holding On For a Rebound in 2010 - Maintain BUY

INVESTMENT CONCLUSION:

During 2009, Aqua America faced strong headwinds including abnormally wet summer weather leading to significant usage declines in the Mid-Atlantic region. Additionally, organic growth slowed amidst a constrained economic environment. Always up to the challenge, Aqua's management did an impressive job weathering the storm by consistently improving its efficiency ratio, accessing low cost debt financing to maintain its capital spending program, and diligently filing for (and receiving) rate relief. The company spent a record \$284 million in capex to improve service reliability and ensure the sustained viability of its earning assets. Though earnings growth has lagged over the past 3-4 years, WTR shares still boast an average annual total return of 11% over the last decade, compared to 5% for the S&P 500 Utilities index and 1% for the Dow. We believe the next two years should show an earnings rebound to the 10-11% range, as macroeconomic factors gradually improve and cost discipline endures. We maintain our BUY rating and \$20 fair value, implying close to 20% total return from current levels.

KEY POINTS:

- **Closing out 2009.** Aqua America reported 4Q and 2009 earnings of \$0.20 and \$0.77 respectively, in line with our estimates. The company managed 7% top and bottom line growth in a difficult operating environment, a result of increased rates and cost discipline (the efficiency ratio improved 150 bps to 40.3%). D&A grew 22% over 2008 to represent 17% of revenue, driven by \$550 million in capital spending in 2008-2009. Despite a higher debt load, the company maintained its credit rating and interest expense increased minimally, as the company accessed low cost financing.
- **Regulatory Update.** Aqua received \$37 million in annualized rate awards in 2009 and another \$6 million so far in 2010. Pending cases total \$65 million, primarily in PA and NJ. The company anticipates filing between \$25-\$30 million in annualized revenue requests and surcharges before the end of 2010. Regulatory management has been a strong point for the company, and it continues to work with regulators on consolidating rate structures to reduce filing costs, regulator resources, and customer rate shock.
- **Recalibrating Estimates.** We think Aqua's historical 10% EPS growth target is back within reach over the next 2 years after a hiatus since 2007. We are adjusting our 2010 EPS estimate to \$0.85 from \$0.89 on lower growth assumptions in the first half of the year. Lackluster revenue growth should rebound when increased rates take effect in 3Q, with 3-4 cents of upside potential if a hot dry summer materializes. We introduce a 2011 estimate of \$0.95, representing 11.5% growth.
- **Valuation.** We believe investors have an attractive opportunity to own one of the nation's most efficient water utilities, with one of the best long-term growth records. Our \$20 fair value is based on our 2011 outlook assuming a P/E multiple of 21x and EV/EBITDA multiple of 10x, at the low end of the company's historical valuation range. When combined with a dividend yield of 3.7%, our fair value target offers total return potential of 18%.



VALUATION SUMMARY:

Aqua's shares have remained in a holding pattern between \$16.50 and \$17.50 recently and are unchanged in 2010 compared to the peer group decline around 1.9% (excluding the 15% increase in SouthWest Water). Investor interest has remained muted, evidenced by a falling 12-month rolling average daily volume trend. Short interest increased 1 million shares in the first half of February to 14.8 million shares (or 17 days to cover).

Currently, the water utility group is trading at an average 2011 P/E multiple of 18.3x (based on consensus estimates) and a price/book multiple of 1.6x. Aqua trades in line with the group multiple on 2011 earnings at 18.5x and at a premium price/book multiple of 2x (due to a relatively high debt/total cap ratio of 57%).

We apply P/E multiples of 23.5x and 21x to 2010 and 2011 earnings, respectively, to generate a \$20 fair value. This translates into assumed 2010 and 2011 EV/EBITDA multiples of 11x and 10x. Aqua's earnings potential remains above that of peers that have a more limited geographic footprint. As a result, we believe a modest premium multiple is deserved given the company's growth prospects, lean cost structure, and regulatory leadership. Our expected 2010 dividend of \$0.59 implies a yield around 3.4%, or 18% total return from current levels.

ADJUSTING OUR FORWARD ASSUMPTIONS:

We have lowered our 2010 EPS estimate to \$0.85 from \$0.89 on lower first half growth assumptions. There isn't much to get excited about in the next two quarters, though we expect the third quarter to benefit from rate increases (PA rate case should impact September) and more normalized consumption patterns. Revenue growth of 8% may prove conservative if Mid-Atlantic summer weather reverts to hotter, drier conditions. We expect the company's 2009 efficiency ratio to reach 39.6%, a 70 bps improvement over 2009. Interest expense should increase 6-7% on a higher debt load and expectations of higher short term rates. We estimate that another \$0.03-\$0.04 cents of upside would stem from a hot, dry summer; however, we have taken a more "base case" view in our current forecast.

We introduce a 2011 EPS estimate of \$0.95, or 11% growth above 2010. Revenue growth of 8% is expected to benefit from almost three quarters of favorable comps on the inclusion of new PA rates (due to take effect around Aug. 2010), and a full year of higher NJ rates (assuming December 2010 approval). Amortization will decline to more normalized levels as the TX rate case regulatory asset is fully worked down. We assume an efficiency ratio of 39.4%, another 20 bps of improvement over 2010's level. We have not adjusted the share count for a potential equity offering in late 2010 or early 2011, which management indicated could be in the range of 1-1.5 million shares (only about 1% dilution).

FOURTH QUARTER AND FULL YEAR RESULTS:

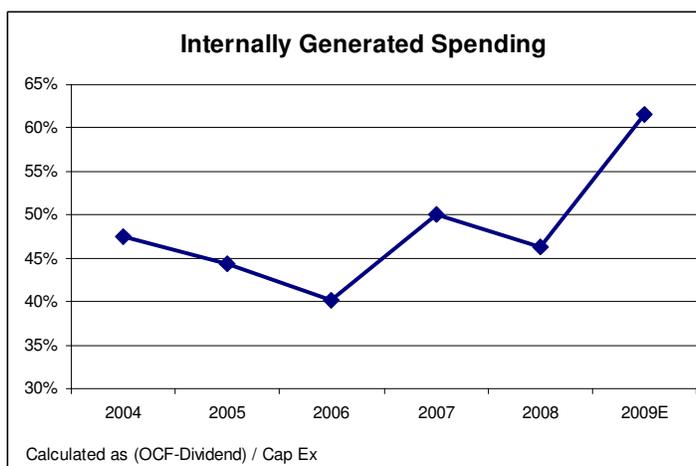
Aqua America reported fourth quarter earnings of \$0.20, in line with our estimate and a penny shy of consensus. The company reported results of \$0.19 per share in the fourth quarter last year. Quarterly revenue increased 5%, below our 6.5% expectation as consumption fell 3-5% due to economic factors (weather is less of a factor in the fourth quarter). Operating cost controls, evidenced by an O&M/revenue ratio below 40%, helped the company earn 36.6% operating margin. Depreciation expenses grew 15% as expected due to investments made in the last year. Interest expense grew 7% to \$19 million on a \$1.7 billion total debt load.

Aqua America (WTR)				
	<u>2008</u>	<u>2009</u>	<u>2010E</u>	<u>2011E</u>
Sales (\$ mil)	627.0	670.5	723.6	785.8
Price/Sales	3.81x	3.56x	3.30x	3.04x
O&M/Revenue	41.8%	40.3%	39.6%	39.4%
EBITDA (\$ mil)	325.4	355.7	390.8	425.7
EBITDA growth	4.8%	9.3%	9.9%	8.9%
Price/EBITDA	7.3x	6.7x	6.1x	5.6x
EV/EBITDA	11.6x	10.6x	9.6x	8.8x
EPS	\$0.73	\$0.77	\$0.85	\$0.95
EPS growth	2.2%	5.5%	11.3%	10.9%
P/E	24.1x	22.8x	20.5x	18.5x
Dividend	\$0.51	\$0.55	\$0.59	\$0.63
Current Data Points:				
Recent Price	\$17.49			
Current Yield	3.4%			
Market cap	\$2.39 bil			
Total debt	1,474 mil			
Total Debt/cap	57.0%			
Book value/Share	\$8.13			
Price/Book	2.2x			
ROE (TTM)	9.6%			

Source: Baseline, JMS Estimates

Looking at 2009 in total, revenue grew 7% to \$671 million, as higher water rates offset significant declines in consumption (due to wet weather and the slumping economy). Management aggressively managed costs and improved the efficiency ratio 150bps to 40.3%. EBITDA growth of 9.3% compared favorably to the 4.8% growth last year; though D&A grew 22% in the year, partially due to some regulatory adjustments, and EBIT margin of 36% dipped from the 37% levels we saw the last two years, a result of a difficult third quarter operating environment. Interest expense grew negligibly, leading to \$0.77 in EPS on 1 million more shares outstanding (mainly due to the company's dividend reinvestment program).

The company spent \$284 million in capex during 2009, up about 10% from 2008 levels, and has plans to spend another \$300 million or so in 2010. The company is using internally generated funds to cover a larger portion of its capital budget – approximately 90% in 2009. Using a rough estimate of operating cash flow less the dividend as a percentage of capex, the chart on the right exhibits the company's ability to fund its capital program internally.



Annual Earnings Statement		Aqua America, Inc.				
<i>(dollars in millions, except per share data)</i>						
<i>FY ends December 31</i>	2007	2008	2009	2010E	2011E	
Total Operating Revenue	\$ 602.50	\$ 626.97	\$ 670.54	\$ 723.57	\$ 785.76	
Expenses						
Operation & Maintenance	253.09	262.12	270.06	286.63	309.92	
Depreciation	83.18	88.79	103.00	111.04	121.98	
Amortization	4.83	5.52	11.94	12.52	8.15	
General Taxes	45.38	44.75	48.08	49.38	53.40	
Total Expenses	386.48	401.17	433.08	459.58	493.45	
Income from Operations	216.02	225.80	237.46	264.00	292.31	
Operating Margin (%)	35.9%	36.0%	35.4%	36.5%	37.2%	
Allow. for Borrowed Funds Used in Const.	2.95	3.67	2.87	3.00	3.00	
Gain (loss) on sale of properties	3.49	1.60	0.47	0.60	0.60	
EBIT	222.46	231.07	240.80	267.24	295.55	
EBIT (%)	36.9%	36.9%	35.9%	36.9%	37.6%	
Interest Expense	66.92	68.57	68.61	72.76	78.00	
Income Before Taxes	155.54	162.50	172.20	194.48	217.55	
Provision for Income Taxes	60.53	64.58	67.84	77.45	86.73	
Implied Tax Rate	38.9%	39.7%	39.4%	39.8%	39.9%	
Net income	\$95.01	\$97.92	\$104.35	\$117.03	\$130.82	
EPS (fully diluted)	\$0.71	\$0.73	\$0.77	\$0.85	\$0.95	
Weighted Avg. Shares	133.6	134.8	136.1	137.2	138.3	

Company Description

Aqua America, Inc. provides water and wastewater utility service to suburban areas outside of Philadelphia, Chicago, and Cleveland, as well as other communities throughout 13 states, including Pennsylvania, New York, Ohio, North Carolina, Illinois, Texas, Florida, New Jersey, Indiana, Virginia, Maine, Missouri, and South Carolina.

IMPORTANT DISCLOSURES

Research Analyst Certification

I, Debra G. Coy and Heike M. Doerr, the Primarily Responsible Analyst for this research report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views I expressed in this research report.

Janney Montgomery Scott LLC ("JMS") Equity Research Disclosure Legend

Janney Montgomery Scott is a market maker in the securities of WTR, and may at any time hold a long or short position in this security.

The research analyst primarily responsible for preparing this research report or a member of the research

analyst's household has a financial interest in the securities of the company in the form of options (O),

warrants (W), futures (F), and/or a short position (S).

Janney Montgomery Scott may seek compensation for investment banking services from the subject company (ies) WTR security in the next 3 months.

The research analyst is compensated based on, in part, Janney Montgomery Scott's profitability, which includes its investment banking revenues.

Definition of Ratings

BUY: Janney expects that the subject company will appreciate in value. Additionally, we expect that the subject company will outperform comparable companies within its sector.

NEUTRAL: Janney believes that the subject company is fairly valued and will perform in line with comparable companies within its sector. Investors may add to current positions on short-term weakness and sell on strength as the valuations or fundamentals become more or less attractive.

SELL: Janney expects that the subject company will likely decline in value and will underperform comparable companies within its sector.

Price Charts



Janney Montgomery Scott Ratings Distribution as of 12/31/09

Rating	IB Serv./Past 12 Mos.			
	Count	Percent	Count	Percent
BUY [B]	164	51.00	15	9.00
NEUTRAL [N]	152	47.00	7	5.00
SELL [S]	5	2.00	0	0.00

***Percentages of each rating category where Janney has performed Investment Banking services over the past 12 months.**

Other Disclosures

Investment opinions are based on each stock's 6-12 month return potential. Our ratings are not based on formal price targets, however our analysts will discuss fair value and/or target price ranges in research reports. Decisions to buy or sell a stock should be based on the investor's investment objectives and risk tolerance and should not rely solely on the rating. Investors should read carefully the entire research report, which provides a more complete discussion of the analyst's views.

This research report is provided for informational purposes only and shall in no event be construed as an offer to sell or a solicitation of an offer to buy any securities. The information described herein is taken from sources which we believe to be reliable, but the accuracy and completeness of such information is not guaranteed by us. The opinions expressed herein may be given only such weight as opinions warrant. This Firm, its officers, directors, employees, or members of their families may have positions in the securities mentioned and may make purchases or sales of such securities from time to time in the open market or otherwise and may sell to or buy from customers such securities on a principal basis. Supporting information related to the recommendation, if any, made in the research report is available upon request.