

Nat Resources & Energy
Water Utilities
Equity – United States

Overweight

Target price (USD)	21.00
Share price (USD)	17.20
Potential return (%)	22.1

Performance	1M	3M	12M
Absolute (%)	1.7	-1.5	3.8
Relative [^] (%)	1.3	5.9	-14.9

Index[^] S&P 500

RIC WTR.N
 Bloomberg WTR US

Market cap (USDm) 2,356

Enterprise value (USDm) 3,918
 Free float (%) 100

Note: (V) = volatile (please see disclosure appendix)

Aqua America

OW: Strong balance sheet underpins earnings growth; 2010, TP increased to USD21 from USD20

- ▶ **Strongest balance sheet and credit rating A+ in our water universe of coverage will drive growth in a climate of budgetary pressure for US municipalities**
- ▶ **2010 EPS increased to USD0.89 from USD0.87, 2011 to USD0.97 from USD0.95 and 2012 to USD1.06 from USD1.04**
- ▶ **Reiterate Overweight rating; TP increased to USD21 from USD20**

Strong balance sheet will drive growth

On 15 June, we accompanied management on a non deal roadshow to visit with investment clients. It was an opportunity for us to review our Aqua America investment proposition. Aqua America has the strongest balance sheet of any of the water companies we cover, with an A+ S&P rating compared to an average rating of BBB+ for both the UK and French water stocks we cover. As water is a capital intensive business, water companies require a stable credit rating to access new debt finance. Aqua, as a regulated water company, is able to grow earnings through acquisitions of both private companies and municipally-owned water systems. In addition, increased investment to upgrade its own water systems is reflected in allowed returns on its growing rate base.

EPS upgrade on acceleration of acquisitions and rate case filings

Aqua America has received a rate case from Pennsylvania allowing an increase in revenues of USD23.6m. This is compared to the company's submission of USD43.2m. We believe the allowed return on equity is above 10%. In addition, on our estimates, it has acquired eight new water systems in 2010 in Illinois, Virginia, Texas, New Jersey, and Pennsylvania and entered Georgia- a new state. We expect this to have a positive effect on revenues and earnings and build a base for further growth in 2011. We are therefore raising our EPS estimates for 2010 to USD0.89 from USD0.87, for 2011 to USD0.97 from USD0.95, and for 2012 to USD1.06 from USD1.04.

Rating and valuation

We value Aqua using December 2010 as the next forecast year and based on four methods – DCF, DDM, sum-of-parts (SOP), and divisional value creation analysis. We take the average of these, USD20.67, and round it to USD21 to obtain our target price (previously USD20). As our target price of USD21 implies a potential total return of 22.1%, we maintain our Overweight rating. Risks to our view include: reduced organic growth in 2010 and rate cases that do not deliver improved returns.

28 June 2010

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Financials & valuation

Financial statements

Year to	12/2009a	12/2010e	12/2011e	12/2012e
Profit & loss summary (USDm)				
Revenue	671	733	795	862
EBITDA	352	395	428	465
Depreciation & amortisation	-115	-124	-131	-137
Operating profit/EBIT	237	271	298	328
Net interest	-69	-71	-77	-80
PBT	172	200	221	247
HSBC PBT	169	200	221	247
Taxation	-68	-79	-87	-97
Net profit	105	121	134	150
HSBC net profit	104	121	134	150

Cash flow summary (USDm)

Cash flow from operations	259	253	272	290
Capex	-321	-300	-300	-300
Cash flow from investment	-321	-300	-300	-300
Dividends	-75	-80	-86	-91
Change in net debt	131	110	80	66
FCF equity	-106	-47	-28	-10

Balance sheet summary (USDm)

Intangible fixed assets	43	43	43	43
Tangible fixed assets	3,454	3,630	3,799	3,962
Current assets	122	130	138	147
Cash & others	22	22	22	22
Total assets	3,763	3,947	4,125	4,297
Operating liabilities	771	787	802	815
Gross debt	1,474	1,583	1,663	1,729
Net debt	1,452	1,562	1,641	1,708
Shareholders funds	1,109	1,167	1,250	1,343
Invested capital	2,826	2,993	3,156	3,316

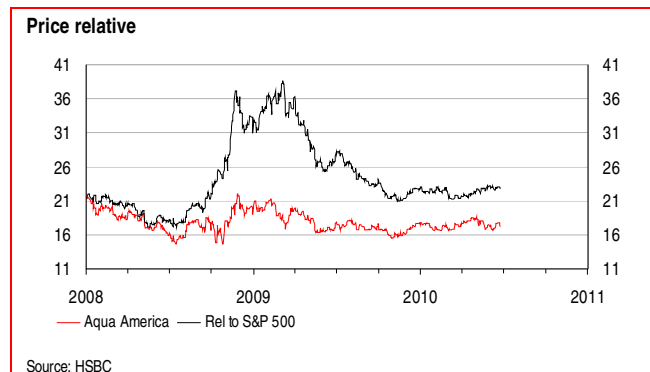
Ratio, growth and per share analysis

Year to	12/2009a	12/2010e	12/2011e	12/2012e
Y-o-y % change				
Revenue	6.9	9.3	8.5	8.5
EBITDA	10.1	12.1	8.5	8.5
Operating profit	5.2	14.3	9.8	10.0
PBT	6.2	16.1	10.6	11.7
HSBC EPS	5.5	15.7	9.0	10.1
Ratios (%)				
Revenue/IC (x)	0.2	0.3	0.3	0.3
ROIC	5.3	5.7	5.9	6.1
ROE	9.6	10.7	11.1	11.6
ROA	4.0	4.3	4.5	4.7
EBITDA margin	52.6	53.9	53.9	53.9
Operating profit margin	35.4	37.0	37.5	38.0
EBITDA/net interest (x)	5.1	5.6	5.6	5.8
Net debt/equity	130.9	133.7	131.2	127.1
Net debt/EBITDA (x)	4.1	4.0	3.8	3.7
CF from operations/net debt	17.8	16.2	16.5	17.0
Per share data (USD)				
EPS reported (fully diluted)	0.77	0.89	0.97	1.06
HSBC EPS (fully diluted)	0.77	0.89	0.97	1.06
DPS	0.55	0.59	0.62	0.65
Book value	8.12	8.53	9.01	9.54

Valuation data

Year to	12/2009a	12/2010e	12/2011e	12/2012e
EV/sales	5.7	5.3	5.0	4.7
EV/EBITDA	10.8	9.9	9.3	8.7
EV/IC	1.3	1.3	1.3	1.2
PE*	22.4	19.4	17.8	16.2
P/Book value	2.1	2.0	1.9	1.8
FCF yield (%)	-4.5	-2.0	-1.2	-0.4
Dividend yield (%)	3.2	3.4	3.6	3.8

Note: * = Based on HSBC EPS (fully diluted)



Note: price at close of 23 Jun 2010

US water market opportunity

The market for operating water and sewer services in the US is estimated at USD47bn to USD53bn pa. The industry is highly fragmented, which provides scope for industry consolidation, which could improve operating efficiencies, lower unit costs, and improve services. Water and waste-water infrastructure in the US is in constant need of modernisation and replacement. Replacement costs for the water and waste-water network and upgrading and extending its treatment facilities are estimated at USD550bn to USD1,000bn over the next 20 years. The Environmental Protection agency (EPA) estimates the country needs to spend USD137bn from 1996-2016 to reach a universal level for sewage treatment. There are 23,748 water systems in 14 states in which Aqua operates and 50,000 systems nationally. Of these, 85% are municipally-owned and 15% privately-owned. In addition to the major capital investments mentioned above, many municipalities are also currently facing financial difficulties. We believe Aqua can grow through acquisitions of both private companies and municipally-owned water systems in this investment climate.

Aqua America 2010 outlook

The company plans to invest more than USD300m in utility-system improvements in 2010. It is also likely to be looking at further acquisitions of private and public water and wastewater systems to drive economies of scale, given its balance sheet strength. It has acquired eight new water systems in 2010. These acquisitions included the municipal water system assets of Bloomsbury Borough in Hunterdon County, New Jersey which serves approximately 1,000 people. The company also acquired the wastewater system assets of Ellwood Greens Utility, which serves approximately 750 people in Genoa, Illinois. In Virginia, the company acquired two water systems that serve approximately 1,400 people in Culpeper, Orange, and Fauquier counties. In Texas, the company acquired the Canyon Spring Water Company, which serves approximately 1,200 people in Comal County and has acquired non-regulated waste water assets in Georgia. It is also reviewing activities in some of the states in which it operates in order to concentrate on states with a favourable regulatory climate and growth opportunities.

Aqua has received rate awards in New York, North Carolina, Missouri, Ohio, and infrastructure surcharges in various states, which will increase revenues by USD12.2m. To this we now add the USD23.6m from the Pennsylvania case and USD4m from a New Jersey case. Excluding these, the company still has more than USD37m of rate cases pending before nine state regulatory bodies including more in Pennsylvania, Virginia, and New Jersey. The company will file a further USD20m of rate requests later in 2010 that are expected to impact 2011 results.

Valuation and rating

We continue to value Aqua using December 2010 as the next forecast year and based on four methods – DCF, DDM, sum-of-parts (SOP), and divisional value creation analysis. This is favourably impacted by our increased earnings estimates. We take the average of these, USD20.67, and round it to USD21 to obtain our target price (previously USD20). Under HSBC's research model, the Neutral band for stocks without a volatility indicator such as Aqua America is five percentage points above and below the hurdle rate of 7.5% for US stocks. For Aqua America, this translates into a Neutral band of 2.5% to 12.5% above the current share price of USD17.20. As our target price of USD21 implies a potential total return of 22.1%, we maintain our Overweight rating.

Aqua America: Summary of valuation

Particulars	USD
Current price as on 23-Jun-10	17.2
DCF	23.15
DDM	24.69
SOP	19.12
Value creation analysis	15.72
Target price (average rounded)	21.00
Potential return	22.1%
Rating	Overweight

Source: HSBC, Thomson Financial Datastream

Negative risks

- ▶ Reduced organic growth in 2010
- ▶ Rate cases that do not deliver improved returns
- ▶ Aqua is unable to maintain cost control
- ▶ Cost of debt increases as Aqua refinances its short-term debt

Aqua America: WACC inputs and DCF valuation

WACC inputs		Equity Valuation	USDm
Cost of debt		+ DCF value	4,418
Pre-tax cost of debt	4.9%	+ ST marketable assets	-
Marginal tax rate	38.9%	+ Value of associates	-
Cost of equity		+ Other assets	311
Risk-free rate	4.0%	EV (asset side)	4,729
Equity risk premium	3.5%	- Net debt (+ if Net cash)	(1,562)
Additional risk premium		- Quasi debt (pension)	-
Beta	0.60	- Value of minorities	(1)
Debt - 40%	3.0%	Total non-equity claims	(1)
Equity - 60%	6.1%	Value of equity	3
Cost of capital	4.9%	Value per share (USD)	23.15

Source: HSBC

Aqua America: DDM valuation (USD)

	Q1	Q2	Q3	Final	Total	% share
Explicit	0.6	0.7	0.7	0.7	2.7	11%
Terminal	5.6	5.5	5.4	5.6	22.0	89%
Value	6.1	6.2	6.1	6.3	24.7	

Source: HSBC

Aqua America: Value creation analysis

	(USDm)
Opening invested capital	2,826
ROIC 2010e on average invested capital	5.7%
WACC	4.9%
Spread of ROCE above WACC	0.8%
Value creation	466
Estimated enterprise value	3,292
Financial and other assets	311
Net debt 2009, pensions & minority	(1,452)
Estimated equity value	2,151
Equity value per share (USD)	15.72

Source: HSBC

Aqua America: SOP valuation (USDm)

	2010e EBITDA	Multiple	EV
Residential water	267	10.0x	2,685
Commercial water	53	8.9x	470
Industrial water	7	8.9x	65
Other water	32	9.2x	294
Wastewater	31	10.0x	310
Other utility	5	9.2x	43
Regulated business	395	9.8x	3,867
Financial and other assets			311
Net debt 2010e, pensions & Minority			-1,562
Estimated equity value			2,616
Equity value per share (USD)			19.12

Source: HSBC, Thomson Financial Datastream

Disclosure appendix

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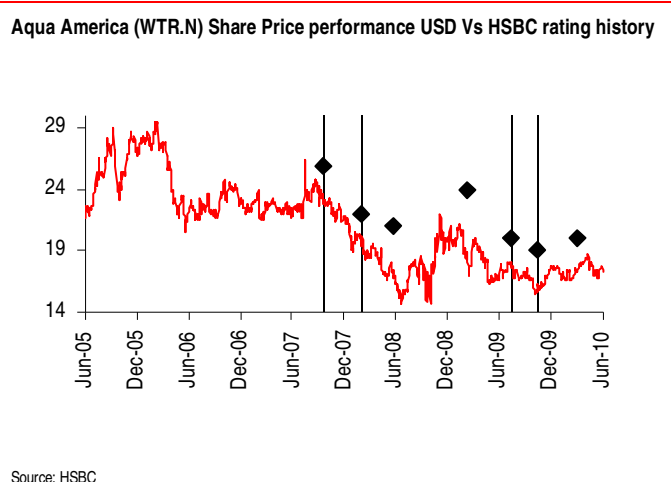
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Overweight (Buy)	52%	(19% of these provided with Investment Banking Services)
Neutral (Hold)	35%	(18% of these provided with Investment Banking Services)
Underweight (Sell)	13%	(16% of these provided with Investment Banking Services)

Share price and rating changes for long-term investment opportunities



Recommendation & price target history

From	To	Date
Overweight	Neutral	09 October 2007
Neutral	Overweight	25 February 2008
Overweight	Neutral (V)	07 August 2009
Neutral (V)	Overweight	06 November 2009
Target Price	Value	Date
Price 1	26.00	09 October 2007
Price 2	22.00	25 February 2008
Price 3	21.00	16 June 2008
Price 4	24.00	05 March 2009
Price 5	20.00	07 August 2009
Price 6	19.00	06 November 2009
Price 7	20.00	23 March 2010

Source: HSBC

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