Edward Jones
MAKING SENSE OF INVESTING

# AQUA AMERICA

Utilities (NYSE: WTR)

**Company Update**

| | |
|---|---|
| **Rating** | **HOLD** |
| **Suitability** | **Growth & Income** |
| **Date** | **May 7, 2010** |
| **Price** | **$18.28** |
| **Dividend** | **$0.58** |
| **Yield** | **3.2%** |

### Company Overview

Aqua America (WTR) is the second-largest publicly traded water utility in the United States, providing water service to roughly 2.8 million residents in 13 different states (Pennsylvania, Texas, Ohio, Illinois, Florida, South Carolina, North Carolina, Virginia, New Jersey, New York, Maine, Indiana and Missouri). The company was incorporated in 1886 in Philadelphia, Pennsylvania.

### Market Data

| | |
|---|---|
| **52-Week Range** | **$18.94 – $15.39** |
| **Market Cap.** | **$2.3bn.** |
| **Div. Pmt. Months** | **Mar Jun Sep Dec** |
| **Est. Earnings Date** | **May 20, 2010** |

| Valuation | 2009A | 2010E | 2011E |
|---|---|---|---|
| **Earnings** | **0.77** | **0.90** | **0.97** |
| **P/E** | **23.7x** | **20.3x** | **18.8x** |
| **PEGY** | **2.6x** | **2.2x** | **2.1x** |

### Growth Outlook

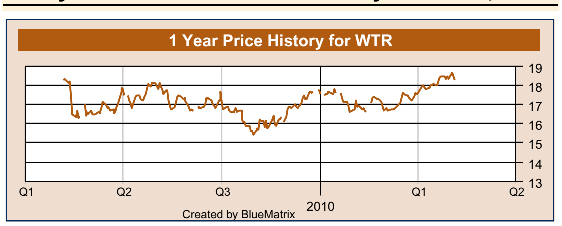
| | |
|---|---|
| **Est. 5-Yr. EPS Growth** | **6%** |
| **Est. 5-Yr. Div. Growth** | **6%** |

### Financial Data

| | |
|---|---|
| **% Revenues International** | **0%** |
| **Debt Ratings (S&P/Moody's)** | **NA/NA** |

*Dividends can be increased, decreased or totally eliminated at any point without notice.*

| | |
|---|---|
| **Headquarters** | **United States of America** |
| **Analyst** | **Andy Pusateri, CFA** |




## INVESTMENT SUMMARY

We rate shares of Aqua America a Hold with a Growth & Income suitability. The company's return to earnings growth is taking longer than expected. However, we believe future rate increases will ultimately result in solid long-term earnings growth and a continuation of dividend increases.

### Return to Earnings Growth Taking Longer than Anticipated

While Aqua America's customer growth has remained significantly above peers, it has struggled to translate this into earnings growth over the last two years. Aqua's more rapid expansion of its business versus peers at a time of significant cost inflation within the industry over the last few years, combined with the standard regulatory lag common to utilities, has been the primary reason why Aqua has shown flat earnings over the last two years. Ultimately, we believe the company will be successful in getting approval for higher customer rates, and the outlook for long-term earnings growth remains solid in our view.

### Growth Through Acquisitions

Aqua America has completed over 200 acquisitions of smaller water systems since 1995. Because of the fragmented nature of the water utility industry as well as the capital needs to repair and maintain infrastructure, we believe that the company will have success in acquiring smaller utility systems and ultimately to earnings growth.

### Future Dividend Increases

We believe WTR has strong management and solid financial strength, making the company well-positioned to continue its track record of annual dividend increases (WTR has paid a dividend for 60 consecutive years and increased its dividend 19 times in the past 18 years).

### Valuation

Shares of Aqua America are currently trading below its historic average and slightly above peers based on several valuation measurements. Given the company's near-term growth challenges, the shares appear appropriately valued.

### Risks

The primary risks to our Hold opinion include adverse regulatory decisions, unusually wet weather, drought restrictions and rising long-term interest rates, which could each negatively impact earnings and the share price. Much of the company's growth is reliant on acquisitions. If the company is unable to successfully acquire smaller water systems, earnings and the stock price may be negatively impacted. Risks to the upside include the ability of the company to return to earnings growth faster than we anticipate.

## RECENT NEWS AND ANALYSIS

05/07/10: Aqua America announced first-quarter 2010 earnings per share of $0.16 per share. This number is slightly below our expectation, but in line with the average analyst estimate. Earnings per share were up 14% versus the same quarter last year. Higher earnings are primarily a result of rate increases during the past year. Operating expenses were up less than one percent and operations and maintenance expense to revenue ratio remained low for the company. While we consider Aqua America the premier water utility operator in the nation, we believe that shares are currently appropriately valued at around 19 times our 2011 earnings estimate. We reiterate our Hold rating on these shares.

2/25/10: Aqua America reported 2009 full-year earnings per share (EPS) of $0.77. This is below our and the Street's estimate of $0.80 per share. While earnings were less than expectations, the company was able to grow earnings by 5.5% in a challenging economic year. Higher earnings year-over-year were driven primarily by higher rates in Aqua's service territory that more than offset higher operating costs as well as higher depreciation costs. We believe that overall this was an average result for the company. We view positively the fact that Aqua is showing signs of translating customer growth into earnings growth. While organic growth is likely to remain below historic levels, we still believe that Aqua America can benefit from growth through acquisitions of smaller water systems. We expect this activity to pick up in 2010. We are maintaining our 2010 earnings per share estimate of $0.90, and we are initiating a 2011 EPS estimate of $0.97 per share.

11/03/09: Aqua America announced third-quarter earnings per share (EPS) of $0.25. These results are in line with the consensus estimate of $0.25 per share and below our estimate of $0.26 per share. Lower earnings year-over-year were primarily due to unfavorable weather conditions (very wet conditions in the service territory), which the company estimates resulted in an approximate $0.03 per share reduction in earnings. Third-quarter 2008 earnings included $0.02 from an asset sale. Excluding that sale, earnings were actually slightly higher in the third-quarter 2009. Aqua currently has the lowest efficiency ratio (operations and maintenance expense to revenue) of the major water utilities, and cost containment is something that we expect the company to continue to work on going forward. Overall, we believe this was a positive quarter for the company given the difficult environment and unusually wet quarter. We are comfortable with our 2009 EPS estimate of $0.80 per share. Positive rate relief will be important to the future growth of earnings for Aqua America. The company currently has $12 million in pending rate cases and plans to file an additional $57 million in the fourth quarter of this year. The company also affirmed its plan (originally announced in August of this year) to raise the dividend 7.4% to $0.58 per share annually, beginning with the December dividend.

## INDUSTRY AND COMPANY OUTLOOK

Our outlook for the utility sector is quite positive as we see average annual earnings growth of about 5% going forward, much improved from years past. This improved growth outlook primarily reflects our expectations for more spending on utility infrastructure going forward.

It is our view that the utility industry in general has underinvested in infrastructure in recent decades. As a result, much of the utility assets in the U.S. today are old and are in need of maintenance, repair or outright replacement. The various areas needing investment going forward include electric transmission wires, power plants, natural gas pipelines and water utility infrastructure. This investment will be needed to address the effects of aging infrastructure as well as to meet demand related to natural customer growth. Many estimates forecast the potential investment needs to be several hundreds of billions of dollars over the next two or three decades. It is this spending that we believe will accelerate the future earnings growth of many utilities.

In a 2009 needs assessment, the United States Environmental Protection Agency estimated that over $334.8 billion of capital spending will be necessary for United States water systems to replace aging infrastructure and meet water quality standards by the year 2027.

As water utilities spend more on infrastructure, they can earn a regulated return on the invested capital. As a result, earnings can grow faster than they otherwise would absent the increased infrastructure investment. This is why we believe the long-term growth outlook for the industry is improving.

Further, the water utility industry is highly fragmented. There are numerous small water systems, many of which are inefficient and could have a difficult time meeting current and future water quality standards. Accordingly, we believe the potential exists for larger water utility companies like Aqua America to selectively acquire multiple small systems each year, thereby adding to their normal rate of customer growth.

**Aqua America's three main avenues for earnings growth**
Aqua America has three main avenues for earnings growth. First, normal growth in the service area provides some increases in customers and sales. While this growth is currently below historical levels, we expect it to improve as the economy turns around. Second, the company has been aggressive in acquiring smaller water systems, mostly adjacent to its existing systems. The company generally acquires 20 to 30 smaller water systems each year. In July of 2003, the company completed its acquisition of AquaSource, a water and wastewater subsidiary of DQE Incorporated. This acquisition added roughly 130,000 regulated customers and increased the number of states the company conducts business in to 14. The acquisition was immediately accretive to earnings. In addition, we believe that worsening conditions at municipalities could provide Aqua America with the opportunity to acquire more systems at attractive prices. Finally, rate increases can have a significant impact on revenues and earnings. WTR aggressively files rate cases in all of its districts. Overall, we think earnings growth of 6% is achievable.

While Aqua America has grown its customer base at higher levels than peers, this growth hasn't translated into earnings growth as well in recent history. Significant cost inflation combined with regulatory lag have been the primary reasons for the company's lack of earnings growth. However, we do believe that the company will begin to receive better rate increases (more importantly in the South), and see solid longer-term earnings growth.

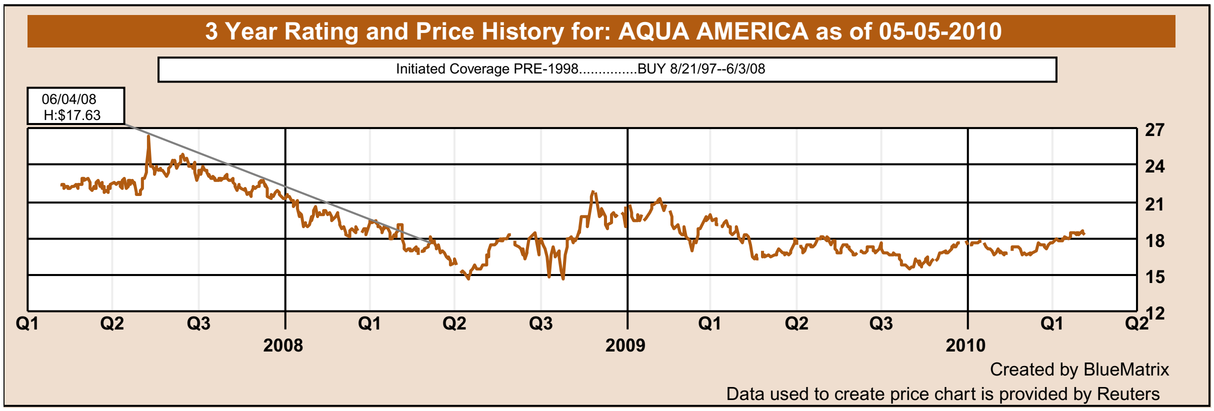
**Dividend Outlook -** Aqua America has paid a dividend for 60 consecutive years and increased it 19 times in the past 18 years (effective with dividend payable 12/01/09). Aqua America's current dividend payout ratio is 67% of our 2009 earnings per share estimate. While this is slightly above peers and higher than the company has had in the past, we believe it is manageable. In our opinion, the company's strong financial position and expected long-term earnings growth will allow the company to meet this goal.

**Regulatory Overview -** Management has constructive relationships with regulators and community leaders. These relationships are necessary for regulated water utilities to grow their asset base and receive timely recovery of spent funds through rate increases. The company has suffered from regulatory lag recently (Regulatory Lag: The time between when costs rise or investments are made and the time utilities are allowed to raise rates to recover and earn higher returns). We believe as the company develops stronger relationships in its Southern states, it will be successful in its goal to continue to recover invested capital and increase regulatory activity. We give Aqua America credit for successfully consolidating its rate divisions from 125 to 25. Overall, we feel that the majority of Aqua America's business is focused in states that provide regulatory recovery mechanisms that will provide more stable future returns and cut back on regulatory lag. For example, the company has approval in Pennsylvania to raise rates quarterly, up to an additional 5%, for capital improvements without filing a request.

## FINANCIAL POSITION

Aqua America's financial position appears strong. Although the company's corporate debt is not rated, the debt of its primary subsidiary, Aqua America-Pennsylvania, is rated 'A+' by Standard & Poor's. As of 9/30/09, Aqua America's capital structure consisted of 55% corporate debt and 45% equity. The company has operating cash flows that are over three times its annual dividends paid. We feel this gives the company sufficient flexibility to continue increasing dividends and invest capital back into the business. In addition, the company has adequate access to capital and enjoys among the lowest costs of debt in the industry.

# Important Research Disclosures




| May 7, 2010 | BUY | HOLD | SELL |
|---|---|---|---|
| Stocks | 60% | 38% | 2% |
| Investment Banking Services | 4% | 2% | 0% |

**The table at left lists the percent of stocks we follow globally in each of our rating categories. Investment banking services indicate the percentage of those companies that have been investment banking clients within the past 12 months.**

| Buy (B) | Hold (H) | Sell (S) | FYI (FI) |
|---|---|---|---|
| Our opinion is to Buy this stock. We believe its fundamentals and/or valuation are compelling. | Our opinion is to keep this stock. We believe the fundamentals and/or valuation are stable. Or a special situation exists, such as a merger, that warrants no action. | Our opinion is to Sell this stock. We believe the fundamentals are deteriorating considerably and/or a recovery is highly uncertain. Or we believe the stock is significantly overvalued. | For information. Factual, no opinion. |

## Analyst Certification

- I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report. Andy Pusateri, CFA

## Important Disclosures

- Edward Jones expects to receive or intends to seek compensation from this company for investment banking services within the next three months.
- Initiated Coverage PRE-1998...............BUY 8/21/97--6/3/08

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- Debt ratings should not be considered an indication of future performance.