October 7, 2009

WELLS FARGO SECURITIES

Equity Research

Aqua America

WTR: Lowering EPS Estimates; Long-term Outlook Remains Strong

Market Perform

Sector: Water Utilities
Market Weight

- **Modestly Adjusting EPS Estimates.** We are lowering our 2009-11E EPS to \$0.80, \$0.88 and \$0.92, respectively, from \$0.82, \$0.89 and \$0.93. The changes primarily reflect adverse 2009 weather impacts as well as lower forecasted usage growth levels over the near-term. After the sizeable backlog of rate relief works it way through the income statement and the earned ROEs in currently depressed states improve, we believe WTR's annual EPS growth rate may revert to a more realistic, low-risk regulated rate of 5-7%, absent significant accretive external growth opportunities. This compares to the water utility industry average annual EPS growth rate of roughly 3-5%. While we forecast above average long-term EPS growth, we continue to rate shares Market Perform given valuation considerations.
- **7.1% Rate Base Growth.** Management indicated at its analyst day that it expects to grow rate base and thus net income at a 7.1% CAGR through 2013. We believe 2013E EPS power is in the \$1.00-\$1.05 range. In addition, WTR's strong balance sheet and A+ credit profile offers flexibility should an attractive sizeable acquisition opportunity present itself.
- **Manageable Financing Needs.** An increasing portion of the CapEx budget is being financed internally thanks to increasing earnings and an expanding depreciable capital base. We project WTR will internally fund roughly 60% of annual investment. Absent a large acquisition, we believe roughly two-thirds of WTR's forecasted equity needs over the next three years can be accomplished via the company's DRIP program.

Valuation Range: \$17.00 to \$18.00
Our relative P/E multiple (applying a roughly 5% premium to the '10 group median of 19X to our '11E EPS) and DDM analyses results in our 12-18 month valuation range. Risks to our valuation range include regulatory risk, the potential undertaking of unprofitable growth ventures and deterioration in the water industry's premium multiple relative to other utility sub-sectors.

Investment Thesis:
We regard WTR as one of the highest quality, fastest growing water utilities. Strong fundamentals include a growing rate base, largely constructive regulation, a disciplined M&A strategy, relatively low risk EPS growth and a growing dividend. Our Market Perform rating largely reflects valuation considerations.

Earnings Estimate Revised Down

	2008A	2009E			2010E	
EPS		**Curr.**		**Prior**	**Curr.**	**Prior**
Q1 (Mar.)	\$0.11	\$0.14	A	NC	NE	
Q2 (June)	0.17	0.19	A	NC	NE	
Q3 (Sep.)	0.26	**0.25**		**0.27**	NE	
Q4 (Dec.)	0.19	0.21		NC	NE	
FY	\$0.73	**\$0.80**		**0.82**	**\$0.88**	**0.89**
CY	\$0.73	\$0.80			\$0.88	
FY P/E	23.0x	21.0x			19.1x	
Rev.(MM)	\$627	\$685			\$747	

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful

Ticker	WTR
Price (10/07/2009)	\$16.80
52-Week Range:	\$12-22
Shares Outstanding: (MM)	135.6
Market Cap.: (MM)	\$2,278.1
S&P 500:	1,054.05
Avg. Daily Vol.:	913,894
Dividend/Yield:	\$0.58/3.5%
LT Debt: (MM)	\$1,228.0
LT Debt/Total Cap.:	50.5%
ROE:	10.0%
3-5 Yr. Est. Growth Rate:	6.0%
CY 2009 Est. P/E-to-Growth:	3.5x
Last Reporting Date:	08/04/2009 *After Close*

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters

Neil Kalton, CFA, Senior Analyst
(314) 955-5239 / neil.kalton@wachovia.com
Jonathan Reeder, Associate Analyst
(314) 955-2462 / jonathan.reeder@wachovia.com
Sarah Akers, Associate Analyst
(314) 955-6209 / sarah.akers@wachovia.com

Please see page 5 for rating definitions, important disclosures and required analyst certifications

Company Description:

Headquartered in Bryn Mawr, PA, Aqua America (WTR) is one of the largest U.S.-based investor-owned regulated water and wastewater utilities. Aqua America, formally Philadelphia Suburban Corporation (PSC), serves approximately 2.8 million residents in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Indiana, Florida, Virginia, Maine, Missouri, and South Carolina. WTR's largest subsidiary, Aqua Pennsylvania, accounts for approximately half of the company's total customer base. The company's aggressive, yet disciplined, growth-through-acquisition strategy has resulted in more than 130 acquisitions and growth ventures adding roughly 250,000 customers over the last five years.

Analyst Day Reflections

WTR management recently conducted an analyst day in New York City. As we anticipated, nothing earth shattering was disclosed. Rather, the company's goal was largely just to reengage itself with Wall St. and the new water utility industry investors as it had been quite some time since WTR held its previous analyst day.

The event provided an opportunity for some of WTR's mid-level managers to gain exposure to the investment community. We believe this is of particular importance given the face of WTR for the past 15+ years has been 64-year old CEO Nicholas DeBenedictis and a changing of the guard must eventually occur – most likely an in-house successor. However, achieving a seamless transition could prove challenging given the investment community's high regard for Mr. DeBenedictis and we believe a portion of WTR's premium valuation is directly attributable to his demonstrated leadership abilities.

In addition, Wendell Holland, former Chairman of the Pennsylvania Public Utilities Commission discussed his views on regulation. We found his regulatory viewpoints to be very constructive and largely atypical of the stereotype Northeast regulator.

EPS Model Tweaked; Lowering Estimates

While WTR's EPS growth has been relatively flat over the past few years, we believe the company is poised to rebound significantly as regulatory lag, particularly at its Southern properties, is resolved.

We are lowering our Q3 to $0.25 from $0.27 given the extremely wet weather during the typically high discretionary demand summer months. Thus, our full year 2009E EPS is now $0.80, down from $0.82. In addition, our new 2010E and 2011E EPS are $0.88 and $0.92, respectively, down from $0.89 and $0.93, respectively, which are mainly attributable to modest downward adjustments to our forecasted usage growth.

We believe the 2008 rate increases, roughly 60% ($36 mm) of which will be incremental to 2009, combined with 2009 received and pending rate awards, will enable WTR to grow 2009 EPS by roughly 10%, despite an overall lousy weather year. Our projection of roughly 10% EPS growth in 2010 reflects both additional rate relief impacts as well as a return to normal weather.

WTR has received $27.4 mm of annual rate awards thus far in 2009, including $13.2 mm related to the Florida and North Carolina cases. The company has multiple small cases pending which ask for roughly $9 mm in increases as well as plans to file approximately $50 mm of rate relief during the remainder of the year with the lion's share representing Pennsylvania ($35-40 mm expected) and New Jersey.

On the expense side, we expect WTR's company-wide operating efficiency ratio (O&M expenses divided by revenues) to decrease by 100-150 bps in 2009. We believe three primary factors will enable this trend: 1) increasing revenue base from significant rate relief implementation 2) more favorable O&M expense comps combined with subsiding inflationary and commodity price pressures and 3) management's propensity to stress now more than ever cost consciousness as the company deals with the challenging economy. The increasing operating margins are counterbalanced by our expectation for other expense categories such as depreciation, amortization and interest to continue to accelerate given the expanding capital base.

Other headwinds include lower organic customer growth and usage rates in addition to modest share dilution. The historically declining residential usage trend (0.5%) has appeared to accelerate somewhat recently which we believe is a combination of both short-term economic pressure as well as a longer-term behavioral shift as consumers begin to recognize the value and increased cost of water service. Though below forecasted usage in between rate filings makes it extremely challenging for a utility to earn its allowed ROE during these periods, WTR believes its frequent rate case cycles, which are necessitated by an aggressive infrastructure replacement/investment program, sufficiently captures recent usage levels and as such, management does not believe the pursuit of revenue decoupling mechanisms across its jurisdictions is warranted at this time.

Strong Long-term EPS Outlook

After the sizeable backlog of rate relief works its way through the income statement and the earned ROEs in currently depressed states improve, we believe WTR's annual EPS growth rate may revert to a more realistic, low-risk regulated rate of 5-7%, absent significant accretive external growth opportunities. Following the forecasted "catch up" in 2009 and 2010, we believe the 10% annual EPS growth that the company historically targeted (and often surpassed) is probably no longer reasonably achievable and/or sustainable going forward given the extraordinary growth the company has experienced in the last decade or so.

We have a great deal of respect for WTR's management, business strategy and work ethic and highlight that a 5-7% long-term EPS growth rate is still above the water utility industry average annual EPS growth rate of roughly 3-5%. In our view, WTR is a fundamentally strong company and management continues to adhere to its proven strategy for achieving profitable growth which revolves around three core philosophies: 1) aggressively invest in its regulated businesses and receive timely rate recognition of the investments, 2) make opportunistic accretive acquisitions of regulated water and wastewater systems and 3) achieve a high level of efficiency through the management of expenses.

In the past six years, the company has nearly doubled in size as a result of the three opportunistic acquisitions of AquaSource, Heater and Florida Water Service in 2003 and 2004, though digesting the growth has proven considerably more challenging than anticipated. WTR purchased the three companies' assets for a combined price of $265 mm and subsequently invested roughly $235 mm in the systems however the recovery timeframe has been much slower than is typical, resulting in significant regulatory lag.

The company moved into areas of the country (the South) where regulators were not as familiar with the water utility business model, the dynamics of the industry and the infrastructure challenges that existed. Though the absolute dollar amount impact to most customer bills in the South region is low relative to other household expenses, especially other utility expenses (i.e. natural gas, electricity, cable), WTR's proposed rate increases on a percentage basis have been significant, thus raising the eyebrows of regulators and consumers at times and ultimately drawing out the recovery process.

In the meantime, WTR's "core" platforms have been performing well which have enabled the utility to absorb the adverse impact of the lag and we believe management is capable of achieving similar returns on its investment at the more recently acquired systems over the next few years. With a total rate base from these acquisitions valued at roughly $460 mm and current earned ROE in the low single digits, the earnings upside potential is significant.

Projecting 7% Rate Base CAGR Through 2013

Management indicated at its analyst day that it expects to grow rate base and thus net income at a 7.1% compounded annual growth rate through 2013. WTR's annual capital budget will continue to focus primarily on relatively low risk infrastructure investments and is expected to average roughly $300 mm per year for the foreseeable future given, amongst other things, the PPUC's recent increase of WTR's DSIC cap to 7.5% of revenues from 5%. With annual CapEx far in excess of depreciation (2009 depreciation projected at approximately $100 mm), the utility's rate base and earnings power will continue to increase.

WTR prioritizes its capital spending in a manner that attempts to maximize the efficient deployment of capital by either focusing investable dollars in states with infrastructure surcharge mechanisms or by syncing significant capital projects appropriately with a jurisdiction's rate case cycle. Roughly 90% of the projected spend is ear-marked for low risk, discretionary infrastructure improvements and the majority of the states where WTR spends the bulk of its CapEx budget have quarterly infrastructure surcharge mechanisms which enable efficient recovery. In essence, the company's CapEx budget is focused on regions where timely recovery is possible and plausible such that regulatory lag is minimized.

With rate base expected to grow from roughly $2.1 B in 2008 to roughly $3.0 B in 2013, we believe 2013E EPS power is in the $1.00-$1.05 range. In addition, WTR's strong balance sheet and A+ credit profile offers the company flexibility should an attractive sizeable acquisition opportunity present itself.

<u>Manageable External Financing Needs</u>

External financing needs appear very manageable given an increasing portion of the CapEx budget is being financed internally thanks to increasing earnings and an expanding depreciable capital base. In addition, approximately $38 mm of additional cash in 2009 is expected from the bonus tax depreciation under the stimulus bill.

We project WTR will internally fund (operating cash flow minus the dividend divided by construction expenditures) roughly 60% of annual investment with the remainder achieved utilizing a combination of debt and equity such that a roughly 44% equity capital structure is upheld. Absent a large acquisition, we believe roughly two-thirds of WTR's forecasted equity needs over the next three years can be accomplished via the company's DRIP program.

Continued 5%+ Dividend Growth

In August, WTR's Board approved an 7.4% increase in the annual dividend effective for the December 1 quarterly payment, raising the annual rate to $0.58 from $0.54. It marks the eleventh consecutive annual acceleration of the dividend above the company's 5% targeted growth rate and the 19th dividend increase in the past 18 years. The new payout ratio represents 66% of our 2010 EPS estimate, which is modestly above management's targeted dividend payout ratio of 55-60% of EPS. Given WTR's low-risk strategy and increased internal cash generation, we believe a payout ratio in the 60-70% range is reasonable and therefore expect future dividend increases closer to the targeted 5% mark.

Need Predictability from Regulators

Though former PPUC Chairman Wendall Holland is roughly 1 year removed from his regulatory role, we consider his comments to still be relevant and reflective of the constructive water regulation that Pennsylvania employs.

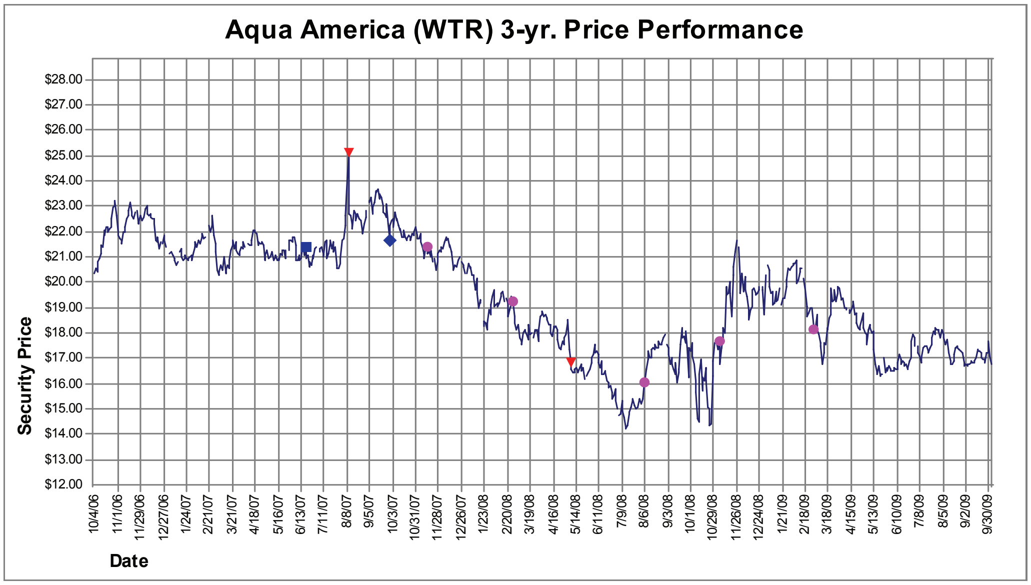
Mr. Holland stressed that a consistent and balanced approach to ratemaking should always be employed such that all constituents involved - customers, the utility and investors – are not caught off guard. This includes upholding the regulatory compact even during challenging economic times or periods of rising prices for other goods and services. Maintaining satisfied customers and a healthy utility while ensuring prices remain fair can be achieved so long as a productive working relationship between the company and the Commission exists and regulatory practices are predictable.

In his view, a regulator's primary concern should revolve around utilities providing a high level of service and reliability to its customers at just and reasonable rates. In order to ensure this, the regulatory framework needs to encourage, enable and reward utilities for achieving these goals. One such policy that Mr. Holland continuously came back to was the infrastructure surcharge mechanism, referred to in Pennsylvania as DSIC (Distribution System Improvement Charge), as it encourages water utilities to invest in pipe replacement which helps improve service quality and reliability while enabling the utility to recover its investment in a timely and predictable manner.

Having adopted a similar philosophy to that expressed by Mr. Holland, we do not believe the slowing economy will have a noticeable impact on WTR's rate case outcomes. In fact, we would argue the credit market disruptions that commenced roughly one year ago have highlighted the importance of state commissioners maintaining the regulatory compact.

We believe regulators realize the central role they play in a regulated utility's ability to raise funds and at what cost. By demonstrating consistency in the ratemaking process and allowing the timely recovery of prudently invested capital at reasonable rates, regulators can provide reassurance to utility investors and ensure utilities maintain adequate liquidity. This is arguably easier to do in regards to water regulation given water rate cases generally fly under the radar somewhat relative to more sizeable and therefore higher profile electric and gas cases.

Required Disclosures



	Date	Publication Price ($)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price ($)
	10/4/2006		Winter			
	10/4/2006	NA	1	25.00	25.00	20.36
■	6/19/2007		Kalton			
▼	8/9/2007	NA	2	NE	NE	25.07
◆	9/28/2007	NA	NR	NE	NE	21.62
● ◆	11/14/2007	22.34	1	24.00	26.00	21.39
●	2/27/2008	19.57	1	22.00	23.00	19.24
▼ ●	5/7/2008	17.99	2	19.00	20.00	16.80
●	8/6/2008	16.42	2	17.00	18.00	16.01
●	11/5/2008	18.04	2	18.00	19.00	17.65
●	3/2/2009	18.40	2	17.00	18.00	18.13

Source: Wells Fargo Securities, LLC estimates and Reuters data

Symbol Key

- ▼ Rating Downgrade
- ▲ Rating Upgrade
- ● Valuation Range Change
- ◆ Initiation, Resumption, Drop or Suspend
- ■ Analyst Change
- □ Split Adjustment

Rating Code Key

1	Outperform/Buy	SR	Suspended
2	Market Perform/Hold	NR	Not Rated
3	Underperform/Sell	NE	No Estimate

Additional Information Available Upon Request

I certify that:
1) All views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers discussed; and
2) No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by me in this research report.

- Wells Fargo Securities, LLC or its affiliates intends to seek or expects to receive compensation for investment banking services in the next three months from Aqua America.
- Wells Fargo Securities, LLC and/or its affiliates, have beneficial ownership of 1% or more of any class of the common stock of Aqua America.

Risks to our valuation range include regulatory risk, the potential undertaking of unprofitable growth ventures and deterioration in the water industry's premium multiple relative to other utility sub-sectors.

Wells Fargo Securities, LLC does not compensate its research analysts based on specific investment banking transactions. Wells Fargo Securities, LLC's research analysts receive compensation that is based upon and impacted by the overall profitability and revenue of the firm, which includes, but is not limited to investment banking revenue.

STOCK RATING

1=Outperform: The stock appears attractively valued, and we believe the stock's total return will exceed that of the market over the next 12 months. BUY
2=Market Perform: The stock appears appropriately valued, and we believe the stock's total return will be in line with the market over the next 12 months. HOLD
3=Underperform: The stock appears overvalued, and we believe the stock's total return will be below the market over the next 12 months. SELL

SECTOR RATING

O=Overweight: Industry expected to outperform the relevant broad market benchmark over the next 12 months.
M=Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.
U=Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

VOLATILITY RATING

V = A stock is defined as volatile if the stock price has fluctuated by +/-20% or greater in at least 8 of the past 24 months or if the analyst expects significant volatility. All IPO stocks are automatically rated volatile within the first 24 months of trading.

As of: October 7, 2009

39% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Outperform.	Wells Fargo Securities, LLC has provided investment banking services for 36% of its Equity Research Outperform-rated companies.
54% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Market Perform.	Wells Fargo Securities, LLC has provided investment banking services for 34% of its Equity Research Market Perform-rated companies.
7% of companies covered by Wells Fargo Securities, LLC Equity Research are rated Underperform.	Wells Fargo Securities, LLC has provided investment banking services for 33% of its Equity Research Underperform-rated companies.

Important Disclosure for International Clients

The securities and related financial instruments described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. For certain non-U.S. institutional reader (including readers in the EEA), this report is distributed by Wells Fargo Securities International Limited (“WFSIL”). For the purposes of Section 21 of the UK Financial Services and Markets Act 2000 (“the Act”), the content of this report has been approved by WFSIL a regulated person under the Act. WFSIL does not deal with retail clients as defined in the Markets in Financial Instruments Directive 2007. This research is not intended for, and should not be relied upon, by retail clients.

Important Information for Australian Recipients

Wells Fargo Securities, LLC is exempt from the requirements to hold an Australian financial services license in respect of the financial services it provides to wholesale clients in Australia. Wells Fargo Securities, LLC is a registered broker-dealer registered with the U.S. Securities and Exchange Commission, and a member of the New York Stock Exchange, the Financial Industry Regulatory Authority, and the Securities Investor Protection Corp. Wells Fargo Securities, LLC is regulated under U.S. laws which differ from Australian laws. Any offer or documentation provided to you by Wells Fargo Securities, LLC in the course of providing the financial services will be prepared in accordance with the laws of the United States and not Australian laws.

Important Information for Recipients in the Hong Kong Special Administrative Region of the People's Republic of China ("Hong Kong")

For recipients resident in Hong Kong, this research is issued and distributed in Hong Kong by Wells Fargo Securities Limited. Wells Fargo Securities Limited is a Hong Kong incorporated investment firm licensed and regulated by the Securities and Futures Commission to carry on types 1, 4, 6 and 9 regulated activities (as defined in the Securities and Futures Ordinance [the "SFO"]). This research is not intended for, and should not be relied on by, any person other than professional investors (as defined in the SFO). The securities and related financial instruments described herein are not intended for sale nor will be sold to any person other than professional investors (as defined in the SFO). Any sale of any securities or related financial instruments described herein will be made in Hong Kong by Wells Fargo Securities Limited. Please consult your Wells Fargo Securities Limited sales representative or the Wells Fargo Securities Limited office in your area for additional information.

Important Information for Japanese Recipients

This material is distributed in Japan by Wells Fargo Securities (Japan) Co., Ltd., a foreign securities company registered with the Financial Services Agency in Japan.

Additional Disclosures

Wells Fargo Securities, LLC is a U.S. broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the New York Stock Exchange, the Financial Industry Regulatory Authority and the Securities Investor Protection Corp. Wells Fargo Securities International Limited is a U.K. incorporated investment firm authorized and regulated by the Financial Services Authority.

This report is for your information only and is not an offer to sell, or a solicitation of an offer to buy, the securities or instruments named or described in this report. Interested parties are advised to contact the entity with which they deal, or the entity that provided this report to them, if they desire further information. The information in this report has been obtained or derived from sources believed by Wells Fargo Securities, LLC, to be reliable, but Wells Fargo Securities, LLC, does not represent that thisinformation is accurate or complete. Any opinions or estimates contained in this report represent the judgment of Wells Fargo Securities, LLC, at this time, and are subject to change without notice. For the purposes of the U.K. Financial Services Authority's rules, this report constitutes impartial investment research. Each of Wells Fargo Securities, LLC, and Wells Fargo Securities International Limited is a separate legal entity and distinct from affiliated banks.