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Gabelli & Company, Inc.

Aqua America (WTR - $16.73 - NYSE) Positioned to Grow - Buy

Year	EPS	P/E	PMV
2011P	$1.00	16.7X	$26
2010E	0.88	19.0	25
2009A	0.77	21.8	24
2008A	0.73	23.0	-

Dividend: $0.58 Current Return: 3.5%
Shares O/S: 136.6 million
52-Week Range: $20.37 - $15.39

SUMMARY AND OPINION

Aqua America is a national water utility serving roughly 3 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. We regard WTR as a low-risk, high quality conservative utility with unique growth opportunities. As the second-largest regulated water utility in the nation, WTR benefits from public and regulatory support of water and wastewater infrastructure investment. In addition, the company's national presence, diverse geographic footprint, technical expertise, operating reputation and financial resources favorably position it to consolidate and privatize the extremely fragmented and municipally-dominated water and wastewater industry. Over the past 15 years, the company has completed more than 235 growth ventures, which have tripled its customer base.

- We continue to recommend purchase of WTR share given a low-risk profile, strong financial condition and dividend and earnings growth potential. The water utility business is one of the lower risk businesses in the U.S. economy and offers unique growth potential due to water infrastructure needs and opportunities related to consolidation and privatization. As one of the larger water utilities with a highly regarded management team, we believe WTR is well positioned to grow earnings and shareholder value.

- Shares offer a competitive current return of 3.5% on the $0.58 annual dividend. On August 4, 2009, WTR raised the dividend rate by $0.04, or 7.4%, to $0.58 from $0.54, which represented the nineteenth increase in the last 18 years that the dividend has been increased. The current dividend represents a conservative 66% of our 2010 EPS estimate of $0.88, which provides ample room for further growth.

- Our 2010 and 2011 earnings estimates are $0.88 and $1.00, respectively, per share. 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 relatively new Southern region, customer growth and increased operational efficiency. Earnings growth in the second-half of 2010 and 2011 will likely benefit from pending rate requests in Pennsylvania and New Jersey as well as several other smaller jurisdictions.

- WTR subsidiaries were granted rate relief in 2009 designed to increase annual operating revenues by $37 million, including infrastructure improvement surcharges in Illinois, Indiana, Ohio, and Pennsylvania. Through the first two months of 2010, WTR subsidiaries were authorized revenue increases totaling $6 million and have $65 million in revenue requests pending, including larger subsidiaries in Pennsylvania ($43 million) and New Jersey ($7.2 million). Management anticipates filing for an additional $30 million in rate requests in 2010, which would primarily impact 2011 results.

- WTR has ample access to capital as evidenced by its balance sheet (43% common equity) and A+ rated senior corporate debt. WTR boasts among the highest credit ratings of any publicly-traded utility and its overall embedded cost of debt is 5.6%.

EPS Outlook

Our 2010 and 2011 earnings estimates are $0.88 and $1.00, respectively, per share. 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 relatively new Southern region, customer growth and increased operational efficiency. While the company reported 2009 earnings of $0.77 per share, we estimate WTRs weather-normalized earnings would have been $0.80 per share in 2009. Earnings growth in the second-half of 2010 and 2011 will likely benefit from pending rate requests in Pennsylvania and New Jersey as well as several other smaller jurisdictions.

Per share earnings results were flat over the 2006-2008 period primarily due to large strategic acquisitions made in 2003 and 2004 that required heavy capital spending and improved operating performance prior to the request for rate recognition.

WTR's long-term and successful strategy is focused on the asset ownership model (as opposed to managing municipal systems) where Aqua invests needed capital in company-owned systems, then files rate cases to request a fair, regulated return. The business model has historically been enhanced via growth-through-acquisition to provide new platforms in which to invest capital necessary for environmental improvements. Larger acquisitions in the company's recent history include: Consumers Water Company in 1999 (five states, 230,000 customers); AquaSource in 2003 (six states, 130,000 customers); Heater Utilities (North Carolina) and Florida Water in 2004 (65,000 customers); New York Water Services in 2006 (45,000 customers) and the Aquarion Water Company of Sea Cliff in 2007 (4,300 customers), which are both in New York; and the Village of Manteno, Illinois (4,000 customers).

Rate Case Activity

As mentioned, WTR subsidiaries were granted rate relief in 2009 designed to increase annual operating revenues by $37 million, including infrastructure improvement surcharges in Illinois, Indiana, Ohio, and Pennsylvania. Through the first two months of 2010, WTR subsidiaries were authorized revenue increases totaling $6 million and have $65 million in revenue requests pending, including larger subsidiaries in Pennsylvania ($43 million) and New Jersey ($7.2 million). Management anticipates filing for an additional $30 million in rate requests in 2010, which would primarily impact 2011 results.

On November 18, 2009, WTR filed a $43.2 million general rate case in Pennsylvania, its largest service territory, intended to recognize the nearly $500 million of water system investment since the company's last rate request in 2007. A rate decision is expected sometime in the August/September timeframe. In 2009, the Pennsylvania Public Utility Commission authorized Aqua Pennsylvania 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.

Other states served by WTR with similar infrastructure surcharge mechanisms include Missouri, Indiana, Illinois, Ohio, and New York. Connecticut and Delaware also have pipe investment mechanisms. Given that roughly 60-70% of capital investments are distribution-related, we view the immediate earnings recovery a favorable one.

WTR also plans on filing on its underperforming systems in Florida and North Carolina that the company had previously acquired and is now "catching up" on these jurisdictions' abilities to earn. Management expects filing in these states sometime early this year, which would most likely effect 2011 earnings. We expect the low earned returns in the Florida and Carolina jurisdictions to improve to normal 10% levels by 2012.

2009 Results Rise 5.5% Despite Weather and Economy

On February 24, 2010, Aqua America reported full year 2009 earnings of $0.77 per share compared to $0.73 per share in 2008. The 5.5% increase in per share results was driven by continued rate recognition of investments in utility infrastructure, acquisitions, modest customer growth and cost-control efforts.

We were encouraged by the solid results given that 2009 was one of the cooler and wetter weather years across the diversified service territories as well as one of the weaker economic environments in recent history. System-wide send-out declined roughly "4% to 5%", which management attributed 3% to 4% to weather and 1% to 2% to the economy. Unfavorable weather was highlighted by the wet cool Philadelphia area spring/early summer, which saw 16 days of rain in the month of June and 45 days of rain in the quarter. This compares to 29 days in 2008. In addition, the Northeast experienced significantly cooler temperatures, which negatively impacts discretionary water use. We estimate weather-normalized earnings would have been roughly $0.80 per share. Given the modest exposure to commercial and industrial customers (roughly 18-19% of retail revenue), earnings results were relatively resilient to the economic recession.

WTR added roughly 10,000 customers, or nearly 1%, in 2009 as the weak economy continues to negatively impact organic growth. The company completed 18 acquisitions, which added roughly 6,000 customers. Aqua America's organic customer growth has been adversely effected by the national housing slowdown.

In 2008, WTR subsidiaries received rate relief totaling $60 million in additional annual revenue, including $39 million in third quarter increases for Pennsylvania and New Jersey subsidiaries. In 2009, WTR subsidiaries received rate awards totaling $37 million. The 2008 and 2009 rate increases combined to benefit 2009 earnings and more than offset lower consumption and resulted in a nearly 7% increase in revenues.

WTR continues to be among the more efficient water utilities in the nation, which was exemplified by 2009 cost controls. 2009 operating and maintenance expenses rose a modest 3%, but were nearly flat excluding some non-recurring items related to a 2008 system sale and a 2009 regulatory write-off. The full year 2009 O&M/Revenue ratio declined to 40.3%, from 41.8% in 2008.

Capital Expenditure Budget

Capital expenditures totaled $283.6 million in 2009 and management expects to invest over $300 million in 2010. A significant portion of the expenditure budget is dedicated to pipe replacement, which is subject to infrastructure surcharges and on which WTR earns nearly immediate returns. The five-year capital budget is currently estimated at $1.5 billion

The capital budget over the 2004-2008 period included more significant compliance spending in the Southeast where larger troubled systems were acquired in 2003-2004, but this type of spending has declined to less than 10% of the overall budget. We also expect WTR to spend roughly $20-30 million per annum on acquisitions of smaller systems. Given the decline in normal organic customer growth to below 1%, from historic 1-2% levels, due to the housing slowdown, WTR targets acquisitions of smaller systems challenged by the economic environment.

We expect internally-generated funding to cover roughly 85% of the company's 2010 capital spending budget. However, WTR will likely publicly issue roughly $25-50 million in common equity in 2010/2011. WTR has ample access to capital as evidenced by its balance sheet (42.9% 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 5.6%.

Dividend Policy

On August 4, 2009, the WTR Board raised the annual dividend by $0.04, or 7.4%, to $0.58 from $0.54, which represents the nineteenth time in the last 18 years that the dividend has been increased. The $0.58 annual rate represents 66% of our 2010 EPS estimate of $0.88.

Valuation

WTR shares currently trade at 19.0X and 16.7X our 2010 and 2011 earnings estimates and 206% of book value, which compares to group multiples of 19.7X and 18.0X and 184% 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 a takeover of WTR would require a 300-325% premium to book value, or $25-27 per share, 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. 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.

Table 1 **Aqua America Private Market Value Analysis, 2004-2012P**

($ in millions, except per share data)	2004A	2005A	2006A	2007A	2008A	2009A	2010E	2011P	2012P
Utility Revenue	$442.0	$496.8	$533.5	$602.5	$627.0	$630.9	$645.7	$669.1	$693.3
Utility EBITDA	235.4	260.9	281.6	305.6	319.9	355.7	392.3	433.7	466.8
Book Value	749.5	811.9	921.6	976.3	1,058.4	1,109.5	1,149.4	1,198.3	1,258.2
Multiple	2.5	2.5	2.5	2.5	2.5	3.0	3.0	3.0	3.0
Value of regulated utilities	$1,873.7	$2,029.8	$2,304.1	$2,440.7	$2,646.1	$3,328.4	$3,448.3	$3,594.9	$3,774.7
Less: Net Options Payments (1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Private Market Value	$1,873.7	$2,029.8	$2,304.1	$2,440.7	$2,646.1	$3,328.4	$3,448.3	$3,594.9	$3,774.7
Shares outstanding	125.7	129.2	131.8	133.6	134.7	136.1	136.8	137.3	137.8
PMV per share	$15	$16	$17	$18	$20	$24	$25	$26	$27
Discount to PMV	*-12%*	*-6%*	*4%*	*8%*	*15%*	*32%*	*34%*	*36%*	*39%*
EPS	$0.64	$0.71	$0.70	$0.71	$0.73	$0.77	$0.88	$1.00	$1.10
P/E	26.3	23.7	24.0	23.5	23.0	21.8	19.0	16.7	15.2
Year End Book Value	$5.84	$6.26	$6.93	$7.28	$7.82	$8.13	$8.39	$8.71	$9.12
P/B	286%	267%	241%	230%	214%	206%	199%	192%	183%
ROE	11.4%	11.7%	10.6%	10.0%	9.6%	9.6%	10.6%	11.7%	12.4%

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

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

<u>Other Companies Mentioned:</u>
Southwest Water Co. (SWWC – NASDAQ)

Aqua America
Price Performance Since Initial Recommendation

Source: Public Data. On August 6, 2007 we placed a HOLD on WTR at a price of $22.21, and a BUY on August 7, 2009 at a price of $17.78.

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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<u>Important Disclosures</u>

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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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