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November 10, 2010

Gabelli & Company, Inc.

Aqua America (WTR - $21.58 - NYSE) Low Risk & 8-10% Growth - Buy

Year	EPS	P/E	PMV	
2012P	$1.08	20.0x	$28	Dividend: $0.62 Current Return: 2.9%
2011P	0.98	22.0	27	Shares O/S: 137.4 million
2010E	0.90	24.0	25	52-Week Range: $21.97 - $15.66
2009A	0.77	28.2	-	

SUMMARY AND OPINION

Aqua America is a national water utility serving roughly three 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.

- WTR reported third quarter earnings of $0.32 per share compared to $0.25 per share for the same period last year. For the first nine-months of 2010 earnings were $0.69 per share compared with $0.57 per share for the same period last year.

Table 1 **Aqua America Third-Quarter and Nine-Month Results**

($ in millions, except per share data)

	Third Quarter			Nine Months		
	2009	2010	Change	2009	2010	Change
EBITDA	$ 96.9	$ 117.3	21.1%	$ 253.9	$ 286.8	13.0%
Net Income	33.5	43.8	30.7	77.7	95.1	22.4
EPS	$ 0.25	$ 0.32	28.0	$ 0.57	$ 0.69	21.1

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

- Third quarter results benefitted from hot and dry weather in the East, which led to a 9% increase in customer usage in key operating areas compared to the same period in 2009. NJ, OH and PA water consumption rose 30%, 12% and 10%, respectively, in the quarter year-over-year. Consumption in TX, IL, and IN rose modestly while VA was flat and FL was down.

- Both the third quarter and year-to-date results benefitted from $49 million in annual rate increases implemented year-to-date, including rate awards in PA, NJ, NY, NC, MO, OH, IN, ME, and VA. The company has $19.1 million in annual rate requests pending and expects to file for an additional $11.5 million in rate requests later in 2010.

- The first nine-months of 2010 O&M/Revenue ratio was 38.4% compared with 40.6% for the same period last year. In 2009, the ratio declined to 40.3%, from 41.8% in 2008. WTR is on target to achieve 2010 EBITDA of $400 million versus roughly $350 million in 2009.

- We have revised our 2010, 2011 and 2012 earnings estimates to $0.90, $0.98 and $1.08, respectively, from $0.88, $1.00 and $1.10, respectively. Our estimates result in nearly 12% annual growth over the 2009-2012 period and 9.3% annual growth over the 2010-2012 period.

- We regard WTR as a well-managed, low-risk, high quality conservative utility with unique growth opportunities. As the second-largest regulated water utility in the nation, WTR's national presence, diverse geographic footprint, technical expertise, operating reputation and financial resources favorably position it to consolidate the fragmented water industry. Over the past 15 years, the company has completed more than 235 growth ventures, and tripled its customer base.

Back on Track For 8-10% EPS Growth

We have revised our 2010, 2011 and 2012 earnings estimates to $0.90, $0.98 and $1.08, respectively, from $0.88, $1.00 and $1.10, respectively. The higher 2010 estimate reflects strong year-to-date results and the modest revision to 2011 and 2012 reflects an expectation of slower annual organic customer growth of 1% from our previous optimistic assumption of a return to 1.5% organic growth. Our estimates result in nearly 12% annual earnings growth over the 2009-2012 period and 9.3% annual growth over the 2010-2012 period. Earnings growth will be driven by rate relief, including large revenue increases in Pennsylvania ($24 million) and New Jersey ($4 million) in mid 2010, the acquisition of smaller systems, and continued cost control. Notably, WTR's cash generation condition continues to improve driven by frequent infrastructure improvement surcharges where nearly immediate returns are earned on a capital investment.

We expect that WTR's annual earnings growth will be roughly 8-10% per annum, which is in line with the long-term historic target rate. Flat earnings over the 2006-2009 time-frame were the result of the strategic acquisitions of troubled southern systems in the higher growth regions of North Carolina and Florida in 2004 and 2005. Given that management has spent several years working to improve operational performance and earned returns, we expect continued rate relief and efficiency improvement to improve returns to normal 10% levels by 2012.

So far in 2010, WTR completed 14 acquisitions of water or wastewater systems and management believes there is currently an uptick in deal activity and hopes to achieve its long term target of 20-30 acquisitions per year, up from 18 in 2009. Acquisitions added roughly 0.5% to customer growth in 2009 and are expected to add closer to 0.75% in 2010. We expect WTR to spend roughly $20-30 million per annum on acquisitions of smaller systems and will periodically acquire larger more strategic assets. The recession slowed normal organic customer growth to below 1%, from historic 1-2% levels. As a result of a slowly recovering economy, management expects 1% organic customer growth over the next twelve-months. Longer-term, we expect stronger growth particularly in the Florida, Carolina and Texas areas.

Table 2 Aqua America Private Market Value Analysis, 2006A-2013P

($ in millions, except per share data)	2006A	2007A	2008A	2009A	2010E	2011P	2012P	2013P
Utility Revenue	$533.5	$602.5	$627.0	$670.5	$686.5	$711.4	$737.2	$764.1
Utility EBITDA	281.6	305.6	319.9	355.7	390.6	422.0	457.3	492.3
Book Value	921.6	976.3	1,058.4	1,108.9	1,157.3	1,216.1	1,283.0	1,356.9
Multiple	2.5	2.5	2.5	3.0	3.0	3.0	3.0	3.0
Value of regulated utilities	$2,304.1	$2,440.7	$2,646.1	$3,326.7	$3,471.9	$3,648.3	$3,849.1	$4,070.6
Less: Net Options Payments (1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Private Market Value	$2,304.1	$2,440.7	$2,646.1	$3,326.7	$3,471.9	$3,648.3	$3,849.1	$4,069.6
Shares outstanding	131.8	133.6	134.7	136.1	136.8	137.4	138.1	138.8
PMV per share	$17	$18	$20	$24	$25	$27	$28	$29
Discount to PMV	*-23%*	*-18%*	*-10%*	*12%*	*15%*	*19%*	*23%*	*26%*
EPS	$0.70	$0.71	$0.73	$0.77	$0.90	$0.98	$1.08	$1.16
P/E	30.9	30.3	29.7	28.2	24.0	22.0	20.1	18.5
Year End Book Value	$6.93	$7.28	$7.82	$8.12	$8.45	$8.83	$9.27	$9.75
P/B	311%	296%	276%	266%	256%	244%	233%	221%
ROE	10.6%	10.0%	9.6%	9.6%	10.9%	11.3%	11.9%	12.2%

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

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

Immediate Returns on Pipe Replacement

We expect earnings growth to increasingly benefit from growing recognition of automatic rate adjustments for certain infrastructure investment. In 2009, the Pennsylvania Public Utility Commission authorized Aqua Pennsylvania, WTR's largest subsidiary, 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. States with similar infrastructure surcharge mechanisms include Missouri, Indiana, Illinois, Ohio, and New York. Connecticut and Delaware also have pipe investment mechanisms.

Continued Efficiency Gains

WTR continues to be among the more efficient water utilities in the nation. The first nine-months of 2010 O&M/Revenue ratio was 38.4% compared with 40.6% for the same period last year. In 2009, the ratio declined to 40.3%, from 41.8% in 2008. The improving is ratio is partially a function of continued efficiency gains from the company's southern region water systems, which were acquired in 2004 and 2005, as well as a modest acceleration of revenue growth related to an improving economy, more normal weather and higher rates.

Capital Expenditure Budget

Management invested roughly $239 million of its planned 2010 budget of $300 million through the first nine-months. Given that roughly 60-70% of capital investments are distribution-related, we view the nearly immediate earnings recovery that WTR receives on these investments as a favorable one. The five-year capital budget is currently estimated at $1.5 billion, including $20-30 million from acquisitions.

We expect internally-generated funding to cover roughly 85% of the company's 2010 capital spending budget with any equity needs accomplished via internal programs. WTR has ample access to capital as evidenced by its balance sheet (42.2% 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 among the lowest.

Dividend Policy

On August 3, 2010, the WTR Board raised the annual dividend by $0.04, or 6.9%, to $0.62 from $0.58, which represents the twentieth time in the last 19 years that the dividend has been increased. The $0.62 annual rate represents 69% of our 2010 EPS estimate of $0.90.

Valuation

WTR shares currently trade at 24.0X and 22.2X our 2010 and 2011 earnings estimates and 262% of book value, which compares to group multiples of 21.5X and 19.8X and 197% of book value. Over the past ten years, WTR shares have traded between 15-35X forward earnings and significant premium multiples to the group.

We believe that the Private Market Value of WTR is around $25-27 per share, at a premium of 300-325% to book value, which compares to 250-325% premiums in the last ten takeover agreements, including the recent acquisition of Southwest Water at 268% of tangible book value by a private equity infrastructure group. 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.

Other Companies Mentioned:
Southwest Water Co. (SWWC – NASDAQ)

Aqua America Price Chart

Source: Public Data. As of November 10, 2007 WTR was rated a HOLD and on August 6, 2009 we changed to a BUY.

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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Important Disclosures

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