

Equity Research

Aqua America

WTR: Strong First Half Leads Us To Increase Our EPS Outlook

- Summary.** Solid Q2. Increasing our 2010-12E EPS to \$0.86, \$0.94 and \$1.00 vs \$0.84, \$0.92 and N/E previously. Reiterate Market Perform rating. VR increased to \$19-20 from \$17-18. Our positive biased towards WTR's strategy and EPS growth profile is tempered by valuation considerations. On a forward looking basis, shares trade at roughly 20x our '12E, a modest premium to the water utility 2011E P/E median of 18.5x, which we consider warranted given low risk above avg EPS growth, consistent dividend growth and financial flexibility.
- 2Q10 EPS of \$0.22**, above ours and the consensus \$0.20 est, vs. \$0.19 in 2Q09. Favorable weather and lower than expected O&M costs appear to be the main deltas. Of the 6.6% revenue growth, 3.4% was due to rate increases, 2% weather and the remainder M&A/organic customer growth.
- A Lean Ship.** Benign inflation and cost controls led to a minimal 1% rise in O&M expenses during 1H. Mgmt expects the pace to accelerate during 2H (PA electric rates and pension expense increases) such that annual O&M is 3-4% higher. Given accelerating top-line growth, O&M is expected to constitute a lean 39% of revenues and reflects an impressive 150 bps annual decrease since 2008. We forecast smaller efficiency ratio gains of roughly 50 bps going forward.
- Increasing EPS Outlook.** We are adjusting our model to reflect lower O&M levels and updated rate relief. Our 2010-12E EPS are \$0.86, \$0.94 and \$1.00 vs \$0.84, \$0.92 and N/E previously. Our '10E largely assumes normal weather for 2H despite the fact that mgmt indicated July continued the better than normal trend. EPS drivers include the usual suspects – rate relief, O&M expense control and opportunistic M&A growth – as mgmt adheres to its proven strategy. Rate relief received in 2010 amounts to \$43.7 mm in annual revs (\$23.6 is PA). WTR has \$13.7 mm of rate requests pending with plans to file an additional \$28.5 mm by year-end. In addition, we no longer forecast minor external equity in the next 12-18 months beyond WTR's DRIP program however this does result in a modestly lower than historical 43% equity ratio. Operating cash flow is expected to fund ~85% of 2010's \$300 mm CapEx budget and WTR's strong capital position provides financial flexibility should a significant M&A opportunity arise.
- Constructive PA Outcome.** On 6/16, the PPUC approved the \$23.6 mm settlement that Aqua PA reached with intervenors. The agreement was silent regarding ROE but we believe it will enable the utility to earn an ROE in the 10.5%-11% range (consistent with the 11% ROE authorized in '08). WTR had filed for \$43.2 mm of relief (12% ROE, 52.5% equity and \$1.6 billion rate base.)

Valuation Range: \$19.00 to \$20.00 from \$17.00 to \$18.00

Our VR is based on a relative P/E multiple (applying a 5-10% premium to the '11 group median of 18.5X to our '12E EPS) and DDM analyses. Risks include regulatory risk, potential undertaking of dilutive growth ventures and deterioration in the water industry's premium multiple relative to electric utilities.

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.

Please see page 2 for rating definitions, important disclosures and required analyst certifications

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Market Perform

Sector: Water Utilities

Market Weight

Earnings Estimates Revised Up

EPS	2009A	2010E		2011E	
		Curr.	Prior	Curr.	Prior
Q1 (Mar.)	\$0.14	\$0.15 A	NC	NE	
Q2 (June)	0.19	0.22 A	0.20	NE	
Q3 (Sep.)	0.25	0.28	NC	NE	
Q4 (Dec.)	0.20	0.21	NC	NE	
FY	\$0.77	\$0.86	0.84	\$0.94	0.92
CY	\$0.77	\$0.86		\$0.94	
FY P/E	25.7x	23.0x		21.0x	
Rev.(MM)	\$671	\$721		\$774	

Source: Company Data, Wells Fargo Securities, LLC estimates, and Reuters
 NA = Not Available, NC = No Change, NE = No Estimate, NM = Not Meaningful
 V = Volatile, * = Company is on the Priority Stock List

Ticker	WTR
Price (08/04/2010)	\$19.75
52-Week Range:	\$15-21
Shares Outstanding: (MM)	137.0
Market Cap.: (MM)	\$2,705.8
S&P 500:	1,124.99
Avg. Daily Vol.:	895,600
Dividend/Yield:	\$0.62/3.1%
LT Debt: (MM)	\$1,462.0
LT Debt/Total Cap.:	54.6%
ROE:	10.0%
3-5 Yr. Est. Growth Rate:	6.0%
CY 2010 Est. P/E-to-Growth:	3.8x
Last Reporting Date:	08/03/2010
	After Close

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

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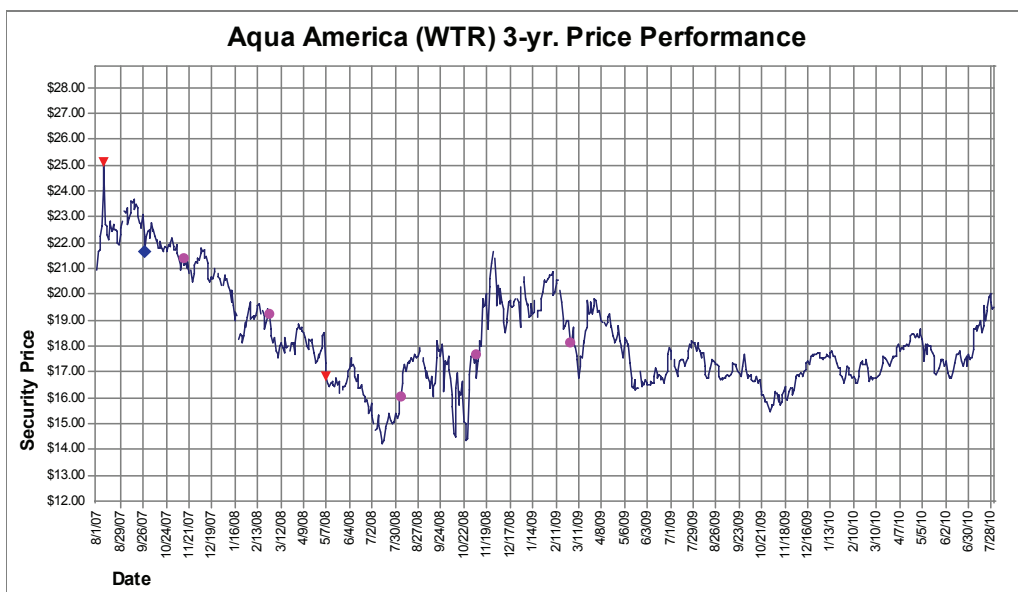
Together we'll go far



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.

Required Disclosures



	Date	Publication Price (\$)	Rating Code	Val. Rng. Low	Val. Rng. High	Close Price (\$)
	8/1/2007		Kalton			
	8/1/2007	NA	1	25.00	25.00	20.90
▼	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 Code Key | |
| ▼ Rating Downgrade | ◆ Initiation, Resumption, Drop or Suspend | 1 Outperform/Buy | SR Suspended |
| ▲ Rating Upgrade | ■ Analyst Change | 2 Market Perform/Hold | NR Not Rated |
| ● Valuation Range Change | □ Split Adjustment | 3 Underperform/Sell | NE No Estimate |

Additional Information Available Upon Request

Aqua America

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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.

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