

**Natural Resources & Energy**  
**Water Utilities**  
**Equity – United States**

## Overweight

Target price (USD)	19.00
Share price (USD)	15.71
Potential total return (%)	20.9

Performance	1M	3M	12M
Absolute (%)	-6.3	-13.3	-11.2
Relative <sup>A</sup> (%)	-8.2	-16.7	-14.7

Index <sup>A</sup>	S&P 500
RIC	WTR.N
Bloomberg	WTR US
Market cap (USDm)	2,135
Enterprise value (USDm)	3675
Free float (%)	100

**6 November 2009**

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# Aqua America

Upgrade to OW: Low growth prospects overdone

- ▶ **Q3 EPS affected by wet weather, -4% y-o-y to USD0.25 from USD0.26, but cost cutting in progress**
- ▶ **Housing growth remains subdued but rate cases will help earnings growth in 2010e; Aqua has debt capacity to grow**
- ▶ **Lowering target price to USD19 from USD20; upgrading to OW from N(V), removing the V flag, on valuation**

**Q3 wet weather but cost-cutting progresses.** Aqua America announced Q3 results on Tuesday, 3 November. Net income was down 5% y-o-y to USD33.5m; EPS decreased by 4% to USD0.25 against USD0.26 in 2008 on 0.8% more shares outstanding. Annualized DPS growth, declared on 4 August, was 7.4% with quarterly DPS of USD0.145. These results were impacted by the loss of revenue due to wet weather in several of its operating areas, including Pennsylvania. Also, the USD0.02 per share gain from the system sale in 3Q08 has made the y-o-y comparisons more adverse.

### Low housing growth remains but successful rate cases underpin earnings growth.

Slow housing growth has continued to affect Aqua America's organic growth. We believe earnings growth should accelerate once the economy and housing market pick up but the pace of recovery may be slower than the market anticipates, so our 2010e EPS of USD0.87 remains below consensus. Aqua America has been granted USD29m of rate cases during 2009 in its various operating areas. It has collective rate requests pending in New York, Indiana, Missouri, Virginia, and North Carolina totalling USD12m, and also expects to seek additional rate relief of cUSD57m through rate filings in 4Q09. We expect the impact of these rate filings to grow the company's revenues in 2010.

### Aqua intends to invest cUSD300m in 2009 and we expect this trend to continue in 2010.

Because of the investment and improvement required in its water network, there has been a significant regulatory lag, which has resulted in invested capital growth exceeding net income growth, which the company is addressing through its filings. This has, in turn, temporarily affected its ROE. The successful filing of its current and future rate cases, coupled with a recovered ROE of c10% in all its areas of activity, would imply CAGR of c7% for its rate base for the period 2008-2013e. This will underpin earnings growth.

**Valuation.** We continue to value Aqua based on December 2010 as the next forecast year, using four methods – DCF, DDM, sum-of-parts (SOP) and divisional value creation analysis. We then take the average of these of USD18.73 and round it up to USD19 (USD20 before) for our new target price.

## Financials & valuation

### Financial statements

Year to	12/2008a	12/2009e	12/2010e	12/2011e
<b>Profit &amp; loss summary (USDm)</b>				
Revenue	627	675	728	786
EBITDA	320	350	384	414
Depreciation & amortisation	-94	-105	-112	-119
Operating profit/EBIT	226	245	271	295
Net interest	-69	-61	-75	-81
PBT	163	184	196	214
HSBC PBT	157	184	196	214
Taxation	-65	-73	-78	-85
Net profit	98	111	118	129
HSBC net profit	98	111	118	129

### Cash flow summary (USDm)

Cash flow from operations	222	174	238	254
Capex	-239	-315	-300	-300
Cash flow from investment	-239	-315	-300	-300
Dividends	-69	-76	-81	-86
Change in net debt	40	217	122	111
FCF equity	-42	-90	-62	-46

### Balance sheet summary (USDm)

Intangible fixed assets	41	41	41	41
Tangible fixed assets	3,219	3,430	3,617	3,798
Current assets	121	121	129	137
Cash & others	15	15	15	15
Total assets	3,485	3,695	3,890	4,080
Operating liabilities	525	534	549	564
Gross debt	1,336	1,553	1,675	1,786
Net debt	1,321	1,538	1,660	1,771
Shareholders funds	1,058	1,093	1,152	1,216
Invested capital	2,842	3,042	3,223	3,398

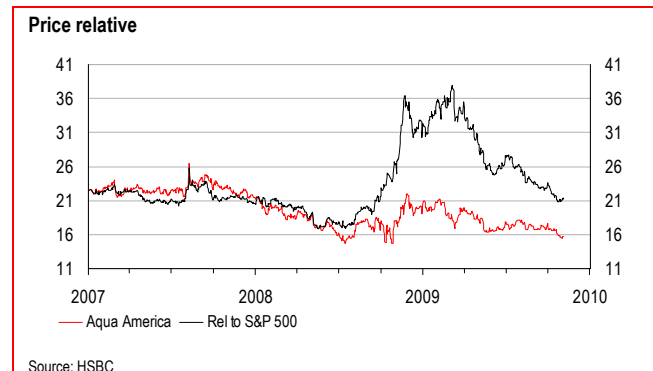
### Ratio, growth and per share analysis

Year to	12/2008a	12/2009e	12/2010e	12/2011e
<b>Y-o-y % change</b>				
Revenue	4.0	7.6	7.9	8.0
EBITDA	5.3	9.4	9.5	8.0
Operating profit	4.5	8.7	10.6	8.8
PBT	4.5	13.2	6.5	9.2
HSBC EPS	2.2	12.2	6.1	7.6
<b>Ratios (%)</b>				
Revenue/IC (x)	0.2	0.2	0.2	0.2
ROIC	5.0	5.0	5.2	5.4
ROE	9.6	10.3	10.5	10.9
ROA	4.1	4.1	4.3	4.5
EBITDA margin	51.1	51.9	52.7	52.7
Operating profit margin	36.0	36.4	37.3	37.6
EBITDA/net interest (x)	4.7	5.7	5.1	5.1
Net debt/equity	124.6	140.4	143.8	145.3
Net debt/EBITDA (x)	4.1	4.4	4.3	4.3
CF from operations/net debt	16.8	11.3	14.3	14.3
<b>Per share data (USD)</b>				
EPS reported (fully diluted)	0.73	0.82	0.87	0.93
HSBC EPS (fully diluted)	0.73	0.82	0.87	0.93
DPS	0.51	0.56	0.59	0.62
Book value	7.82	8.04	8.44	8.78

### Valuation data

Year to	12/2008a	12/2009e	12/2010e	12/2011e
EV/sales	5.5	5.4	5.2	5.0
EV/EBITDA	10.8	10.5	9.9	9.4
EV/IC	1.2	1.2	1.2	1.2
PE*	21.6	19.3	18.2	16.9
P/Book value	2.0	2.0	1.9	1.8
FCF yield (%)	-2.0	-4.2	-2.9	-2.2
Dividend yield (%)	3.2	3.6	3.8	4.0

Note: \* = Based on HSBC EPS (fully diluted)



Note: price at close of 04 Nov 2009

We set out the company's projected rate base growth in the left-hand chart at the bottom of the page.

### Modest growth already priced in?

The stock has already fallen from its 52-week peak at USD21.93 on 26 November 2008 to USD15.45 on 30 October 2009 as the chart on p2 demonstrates.

### Low cost of debt helps to underpin credit capacity

Aqua is benefiting from its strong credit rating of 'A+' and the availability of cheap infrastructure finance. We show this trend in the right-hand chart at the bottom of the page. Aqua has benefited from tax free and other forms of concessionary finance.

## Valuation and rating

We continue to value Aqua based on December 2010 as the next forecast year, using four methods – DCF, DDM, sum-of-parts (SOP) and divisional value creation analysis. We then take the average of these of USD18.73 and round it up to USD19 (USD20 before) for our new target price.

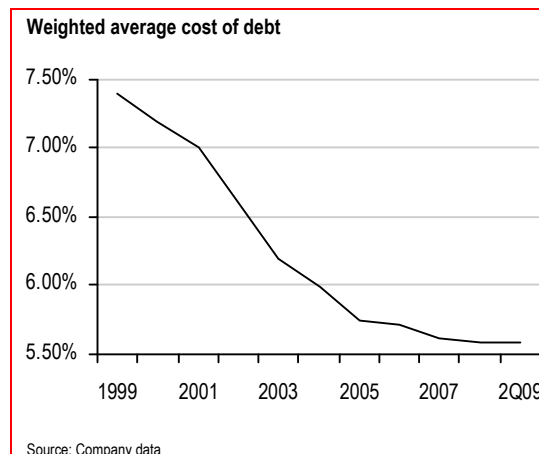
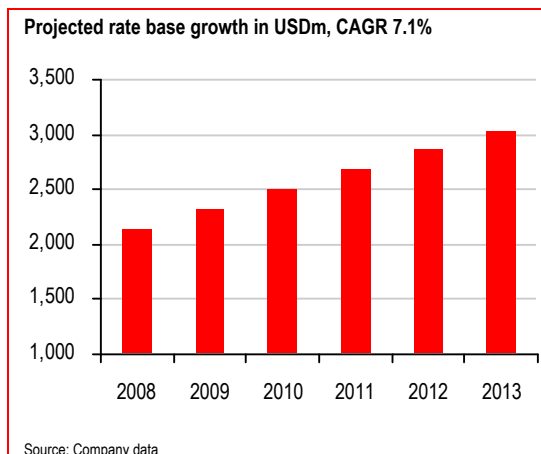
### Summary of valuation

	USD/share
Current price	15.74
DCF	23.07
DDM	22.52
SOP	14.78
Divisional value creation	14.56
<b>Target price (rounded)</b>	<b>19.00</b>
Potential return	20.7%
<b>Rating</b>	<b>Overweight</b>

Source: HSBC estimates

Under HSBC's research model, the Neutral band for stocks without a volatility indicator such as Aqua America is five percentage points above and below the hurdle rate of 7.5% for US stocks. For Aqua America, this translates into a Neutral band of 2.5-12.5% around the current share price of USD15.74. As our target price of USD19 implies a potential total return of 20.7%, we upgrade our rating to Overweight.

Volatile ratings are defined as stocks having historical volatility (defined as the past month's average of the daily 365-day moving average volatilities) of over 40%. As at 4 November 2009, Aqua America scored lower than the threshold on this measure; hence, we remove the volatility (V) flag from our rating.



**DCF:** Our DCF valuation of USD23.07 is based on a terminal growth of 1.5% and a WACC of 4.85%.

<b>DCF valuation</b>	
<b>Equity valuation</b>	<b>USDm</b>
+ DCF value (core operations)	4,537
+ Other assets: real estate, LT investment	275
EV (asset side)	4,812
- Net debt (+ if net cash)	(1,660)
- Value of minorities	(2)
Total non-equity claims/liabilities	(1,662)
<b>Value of equity (EV asset - claims)</b>	<b>3,149</b>
No. of shares (m)	136.5
<b>DCF value per share - (USD)</b>	<b>23.07</b>

Source: HSBC estimates

**DDM:** We assume that Aqua will maintain its annualised DPS growth at 5% for 2010-2013e. Our terminal DPS growth rate is 3.5% and our cost of equity is 6.3%.

<b>DDM valuation (USD)</b>					
<b>DDM split</b>	<b>Q1</b>	<b>Q2</b>	<b>Q3</b>	<b>Final</b>	<b>Total</b>
Explicit	0.55	0.54	0.56	0.73	2.39
Terminal	5.01	4.93	5.10	5.09	20.13
<b>DDM value</b>	<b>5.56</b>	<b>5.48</b>	<b>5.66</b>	<b>5.82</b>	<b>22.52</b>

Source: HSBC estimates

**SOP valuation:** We change our peer group multiples to apply current market multiples to derive our SOP valuation of USD14.78 (USD19.59 before). However, the stock is still trading on 9.9x EV/EBITDA for 2010e against its regulated peers, which are trading at 8.5x. We believe that it deserves a premium rating because of the factors identified above – debt capacity, good cost control, stable management, a focused US strategy and scope for rate base growth.

<b>SOP valuation (USDm except per share data)</b>			
	<b>2010e EBITDA</b>	<b>Multiple</b>	<b>EV</b>
Residential water	267	8.5x	2,275
Commercial water	52	9.8x	512
Industrial water	7	9.8x	66
Other water	26	9.7x	254
Wastewater	26	9.7x	255
Other utility	4	9.7x	42
Regulated business	382	8.9x	3,405
Financial and other assets			275
Net debt 2010e, pensions and minority			(1,662)
Estimated equity value			2,018
<b>Estimated equity value per share (USD)</b>			<b>14.78</b>

Source: HSBC estimates

#### Peer group analysis – residential water

Peer list	Ticker	Current price	EV/EBITDA	PE
American Water Works	U:AWK	19.3	8.5x	13.4x
Cal. Water Ser.	U:CWT	35.8	7.6x	16.9x
American Sts. Water	U:AWR	32.8	7.6x	16.3x
Southwest Water	@SWWC	5.7	8.9x	14.9x
Middlesex Water	@MSEX	15.6	13.1x	19.5x
York Water	@YORW	13.8	11.1x	19.9x
<b>Weighted avg regulated</b>			<b>8.5x</b>	<b>14.7x</b>

Source: HSBC estimates

#### Peer group analysis - others

Peer list	Ticker	Price	EV/EBITDA	PE
ITT	U:ITT	50.9	7.4x	13.0x
Pentair	U:PNR	29.7	9.9x	16.4x
Danaher	U:DHR	70.0	11.0x	18.1x
Nalco Hldg.	U:NLC	21.5	8.5x	17.4x
<b>Weighted average</b>			<b>9.8x</b>	<b>16.7x</b>

Source: HSBC estimates

#### Divisional value creation analysis

	USDm
Capital employed in 2010e	2,829
NOPLAT 2010e	164
Operating ROCE 2010e	5.8%
WACC	4.8%
Spread of ROCE above WACC (before taxes)	0.9%
Value creation	546
<b>Estimated enterprise value</b>	<b>3,375</b>
Financial and other assets	275
Net debt 2010e, pensions & minority	(1,662)
Estimated equity value	1,988
<b>Estimated equity value per share (USD)</b>	<b>14.56</b>

Source: Thomson Financial Datastream

#### Downside risks to our rating

- ▶ Reduced organic growth in Aqua's revenue in 2010
- ▶ Rate cases that do not deliver improved returns
- ▶ Aqua is unable to maintain cost control
- ▶ Cost of debt increases as Aqua refinances its short-term debt

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Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation of coverage, change of volatility status or change in price target). Notwithstanding this, and although ratings are subject to ongoing management review, expected returns will be permitted to move outside the bands as a result of normal share price fluctuations without necessarily triggering a rating change.

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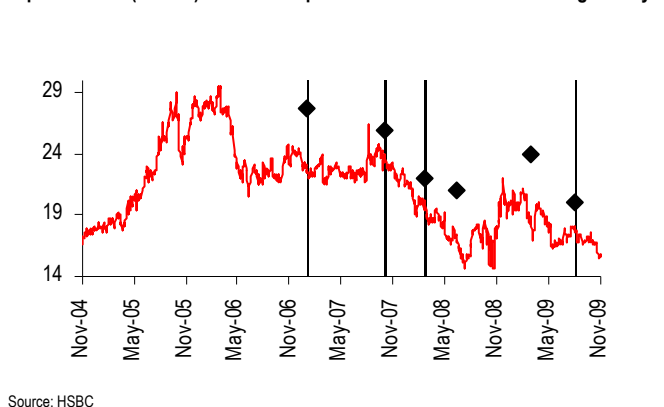
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<b>Neutral (Hold)</b>	38%	(17% of these provided with Investment Banking Services)
<b>Underweight (Sell)</b>	22%	(14% of these provided with Investment Banking Services)

## Share price and rating changes for long-term investment opportunities

Aqua America (WTR.N) Share Price performance USD Vs HSBC rating history



Recommendation & price target history

From	To	Date
Neutral	Overweight	05 January 2007
Overweight	Neutral	09 October 2007
Neutral	Overweight	25 February 2008
Overweight	Neutral (V)	07 August 2009
Target Price	Value	Date
Price 1	27.75	05 January 2007
Price 2	26.00	09 October 2007
Price 3	22.00	25 February 2008
Price 4	21.00	16 June 2008
Price 5	24.00	05 March 2009
Price 6	20.00	07 August 2009

Source: HSBC

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