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Gabelli & Company, Inc.

Aqua America (WTR - $18.05 - NYSE) — Buy

Year	EPS	P/E	PMV	
2012P	$1.10	16.4X	$29	Dividend: $0.58 Current Return: 3.2%
2011P	1.00	18.1	27	Shares O/S: 136.8 million
2010E	0.88	20.6	25	52-Week Range: $18.73 - $15.39
2009A	0.77	23.5	-	

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, and tripled its customer base.

- Our 2010 and 2011 earnings estimates are $0.88 and $1.00, respectively, per share. Earnings growth in the second-half of 2010 and 2011 will likely benefit from expected rate relief in Pennsylvania and New Jersey as well as several other smaller jurisdictions.

- On May 6, 2010, Aqua America reported earnings of $0.15 per share, (excluding a $0.01 per share gain on the sale of stock) compared to $0.14 per share for the similar period in 2009. Net income increased 17% from $18.4 million in the first quarter of 2009 to $21.5 million in the 2010 first quarter. Despite a 1.1% decline in water sales, revenues increased 4% and improved results were achieved due to rate recognition of investments in utility infrastructure.

Aqua America

Table 1

($ millions, excpet per share data)	First Quarter Results 2009	2010
Operating Revenues	$154.5	$160.5
O&M Expense	67.0	67.6
O&M/Revenue Ratio	43.4%	42.1%
Operating Income	$46.8	$50.7
EPS	$0.14	$0.15

Source: Company data

- Management expects to invest over $300 million in 2010, up from $283.6 million in 2009. Roughly 60-70% of capital investments are distribution-related, where the company is often authorized immediate earnings recovery via surcharges.

- Subsidiaries were granted $37 million in rate relief in 2009, including infrastructure improvement surcharges in Illinois, Indiana, Ohio, and Pennsylvania. Year-to-date, WTR subsidiaries were authorized revenue increases totaling $12.2 million and have an additional $65 million in revenue requests pending, including larger subsidiaries in Pennsylvania ($43 million) and New Jersey ($7.2 million). These larger cases are currently in settlement discussions. Management anticipates filing for an additional $20 million in rate requests in 2010, which would primarily impact 2011 results.

EPS Outlook

Our 2010 and 2011 earnings estimates are $0.88 and $1.00, respectively, per share. Earnings growth in the second-half of 2010 and 2011 will likely benefit from expected rate relief in Pennsylvania and New Jersey as well as several other smaller jurisdictions. Longer term, 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.

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 where it is allowed to earn a fair regulated return on the investment. The business model has historically been enhanced via growth-through-acquisition to provide new platforms in which to invest capital. WTR has completed eight acquisitions of water or wastewater systems this year in New Jersey, Illinois, Virginia and Texas. Management believes there is currently an uptick in deal activity and hopes to achieve its long term target of 25-30 acquisitions per year, up from 18 in 2009. 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. However, we expect a recovering economy will lead to recovery in customer growth, particularly in the Florida, Carolina and Texas areas.

Table 2 Aqua America Private Market Value Analysis, 2005A-2013P

($ in millions, except per share data)	2005A	2006A	2007A	2008A	2009A	2010E	2011P	2012P	2013P
Utility Revenue	$496.8	$533.5	$602.5	$627.0	$670.5	$686.5	$711.4	$737.2	$764.1
Utility EBITDA	260.9	281.6	305.6	319.9	355.7	395.6	436.2	466.6	500.8
Book Value	811.9	921.6	976.3	1,058.4	1,108.9	1,154.0	1,215.2	1,346.3	1,425.7
Multiple	2.5	2.5	2.5	2.5	3.0	3.0	3.0	3.0	3.0
Value of regulated utilities	$2,029.8	$2,304.1	$2,440.7	$2,646.1	$3,326.7	$3,462.0	$3,645.6	$4,038.8	$4,277.2
Less: Net Options Payments (1)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.0
Private Market Value	$2,029.8	$2,304.1	$2,440.7	$2,646.1	$3,326.7	$3,462.0	$3,645.6	$4,038.8	$4,276.2
Shares outstanding	129.2	131.8	133.6	134.7	136.1	136.8	137.4	139.5	141.5
PMV per share	$16	$17	$18	$20	$24	$25	$27	$29	$30
Discount to PMV	*-15%*	*-3%*	*1%*	*8%*	*26%*	*29%*	*32%*	*38%*	*40%*
EPS	$0.71	$0.70	$0.71	$0.73	$0.77	$0.88	$1.00	$1.10	$1.20
P/E	25.6	25.9	25.4	24.8	23.5	20.6	18.1	16.4	33,719.3
Year End Book Value	$6.26	$6.93	$7.28	$7.82	$8.12	$8.42	$8.82	$9.53	$10.05
P/B	288%	261%	248%	231%	222%	214%	205%	189%	180%
ROE	11.7%	10.6%	10.0%	9.6%	9.6%	10.6%	11.6%	12.0%	12.2%

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

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

Rate Relief Offsets Sales Decline; Results Higher in First Quarter

On May 6, 2010, Aqua America reported earnings of $0.15 per share (excludes a $0.01 gain on the sale of stock), compared to $0.14 per share for the similar period in 2009. Net income increased 17% from $18.4 million in the first quarter of 2009 to $21.5 million in the 2010 first quarter. Despite a 1.1% decline in water sales, revenues increased 4% and improved results were achieved due to rate recognition of investments in utility infrastructure.

WTR continues to be among the more efficient water utilities in the nation. The first quarter 2010 O&M/Revenue was 42.1% compared with 43.4% for the same period last year. In 2009, the O&M/Revenue ratio declined to 40.3%, from 41.8% in 2008, and the company projects a 50-100 basis point decline in this statistic from 2009 levels in 2010.

Rate Case Activity

Aqua America subsidiaries were granted $37 million in rate relief in 2009, including infrastructure improvement surcharges in Illinois, Indiana, Ohio, and Pennsylvania. Year-to-date, WTR subsidiaries were authorized revenue increases totaling $12.2 million and have $65 million in revenue requests pending, including larger subsidiaries in Pennsylvania ($43 million) and New Jersey ($7.2 million), both of which are currently in settlement discussions. Management anticipates filing for an additional $20 million in rate requests in 2010, which would primarily impact 2011 results.

In addition, we expect WTR to file rate adjustments on its underperforming systems in Florida and North Carolina later this year. The company had previously acquired these southern systems and is now “catching up” on these jurisdictions’ abilities to earn. We expect the low earned returns in the Florida and Carolina jurisdictions to improve to normal 10% levels by 2012.

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.

States with similar infrastructure surcharge mechanisms include Missouri, Indiana, Illinois, Ohio, and New York. Connecticut and Delaware also have pipe investment mechanisms. Management believes that these mechanisms will provide a meaningful revenue enhancement over the next five years.

Capital Expenditure Budget

Management expects to invest over $300 million in 2010, from $283.6 million in 2009. 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. Of this, we forecast WTR to spend roughly $20-30 million per annum on acquisitions of smaller systems.

We expect internally-generated funding to cover roughly 85% of the company’s 2010 capital spending budget. WTR will likely publicly issue roughly $25-50 million in common equity in 2010/2011, aiming to achieve no more than 1% dilution. 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. S&P recently reiterated Aqua Pennsylvania’s, WTR’s largest subsidiary, A+ credit rating. WTR boasts among the highest credit ratings of any publicly-traded utility and its overall embedded cost of debt is 5.4% as of the end of the quarter. The company has stated it will aim to refinance some debt in 2010 to take advantage of its balance sheet and current interest rate environment.

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

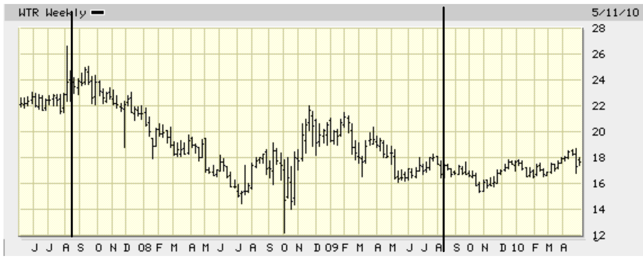
WTR shares currently trade at 20.6X and 18.1X our 2010 and 2011 earnings estimates and 214% of book value, which compares to group multiples of 21.6X and 19.7X and 185% of book value. Over the past ten years, WTR shares have traded between 15-35X forward earnings and significant premium multiples to 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 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 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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Important Disclosures

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Ratings
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.
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