

Water

Aqua America, Inc.

(WTR) - BUY

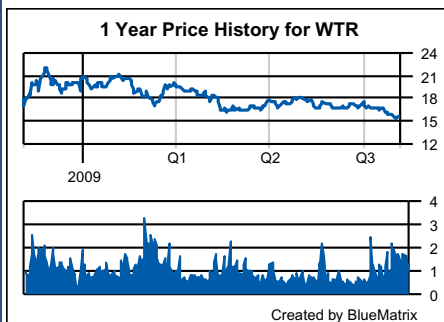
Price: **\$15.71**
 Fair Value Estimate: \$20.00
 52-Week Range: \$22.00-\$15.39
 Market Cap (MM): \$2,135
 Shr.O/S-Diluted (mm): 135.9
 Average Daily Volume: 911,890
 Dividend: \$0.58
 Yield: 3.7%

FYE: Dec	2008A	2009E	2010E
EPS:	\$0.73	\$0.77	\$0.89
Prior EPS:		NC	\$0.88
P/E Ratio:	21.5x	20.4x	17.7x

Quarterly EPS:

Quarter	2008A	2009E	2010E
Q1	\$0.11	\$0.14A	\$0.16
Q2	\$0.17	\$0.19A	\$0.24
Q3	\$0.26	\$0.25	\$0.28
Q4	\$0.19	\$0.20	\$0.22

EPS: Annual estimate under review; does not reflect actual 2Q09 results or post-earnings model adjustments



Equity Research
Note

Executing on Strategy - Results Masked by Weather; Reiterate BUY

INVESTMENT CONCLUSION:

Aqua reported flat year-over-year operating results, well below its targeted growth but not bad considering continued weather and economic headwinds. Year-to-date, reduced water usage has resulted in an estimated earnings drag of \$0.05-\$0.06 per share, largely offsetting the benefit of new rate awards. For 2010, we believe our forecast of ~15% EPS growth is achievable, assuming the weather gets back to normal, as rate cases continue to flow. Despite external challenges, Aqua's operating performance has been strong, and we believe the company is executing well on its longer-term strategy. It is accessing low-interest financing, putting those dollars to work, and translating these capital outlays into rates more quickly through infrastructure surcharge mechanisms. We maintain our BUY rating and \$20 fair value and believe the current share price offers investors an attractive entry point.

KEY POINTS:

- Third Quarter Results.** Aqua America reported third quarter earnings of \$0.25, in line with our estimate and consensus. The company reported results of \$0.26 per share in the third quarter last year, which included a 2-cent gain for the sale of an Illinois water system and a 1-cent one-time, non-cash charge associated with finalizing the Texas rate case. These flat year-over-year operating results were achieved despite an 11% usage decline in the company's core Mid-Atlantic region, thanks to strong operating cost controls. The company estimated that wet weather had a negative 3-cent impact on earnings in the quarter.
- Regulatory Update.** Aqua has received \$29 million in rate awards year to date and has approximately \$12 million in additional rate cases pending, with the largest requests pending in North Carolina and New York. We expect the company to file for an additional \$57 million in increased rates in Pennsylvania and New Jersey before year end. This will bring full-year filings to about \$75 million, with new rates to flow in 2010 and 2011. As the company is finally getting close to caught up in its under-earning southern territories, more of its investment will be focused on states that allow infrastructure surcharge mechanisms that improve the timeliness of returns on investment.
- Valuation.** With the shares having pulled back recently, we believe investors have an attractive opportunity to initiate or add to positions of Aqua America at current levels. Our \$20 fair value is based on our 2010 outlook, which assumes that the company can show an earnings rebound of 15% in 2010, applying a P/E multiple of 22x and EV/EBITDA multiple of 10.4x, still below the midpoint of the company's 5-year trading range. Combined with a dividend yield of 3.7%, our fair value target offers total return potential of 30%.

Research Analyst Certifications and Important Disclosures are on pages 5 - 6 of this report

THE VALUATION DEBATE:

Aqua has underperformed its peer group for most of the year, down almost 24%, compared to the modest group average improvement of 2%. A large portion of this decline has come in the past few weeks as the stock slid over 10% since September 30th, while the water utility group average was flat. Utilities in general have underperformed the market in 2009, as the Dow Jones Utility Index is down 2.5% compared to the Dow Jones gain of 11%, and S&P appreciation of 16%.

Currently, Aqua's stock not only trades at the low end of its five year valuation range, but is also trading below the group average on an EV/EBITDA and P/E basis, an almost unprecedented position for the stock, which has almost always traded at a premium to peers. The water utility group is trading at an average 2010 P/E multiples of 19.0x, a 2010 EV/EBITDA multiple of 9.6x, and a price/book multiple of 1.7x. Aqua trades at a 2010 P/E multiple of 17.7x, a 2010 EV/EBITDA multiple of 8.9x, and price/book multiple of 2.0x.

Despite the recent valuation contraction and seemingly attractive entry point relative to historical multiples, investors still question whether valuation will continue to contract, or whether the recent contraction will persist. American Water, Aqua's closest comp, trades at a P/E multiple of only 13x our 2010 estimate and an EV/EBITDA of 8.3x, more similar to electric utilities than its water utility brethren. The million dollar question seems to be: "Will Aqua contract to American's valuation, or the other way around?"

We acknowledge that for some investors, water utilities will not look "cheap" until they are trading in the low-teens, in line with electric utilities. However, we believe that some premium for the water utility group (compared to the electric/gas utilities) is warranted, though, to what degree is difficult to determine. The water utilities boast higher debt ratings, and consequently have lower debt costs (keeping rates down for consumers). They can also issue tax-exempt debt in some states through state revolving funds. Due to relatively low household bills and smaller dollar-amount rate requests, decisions for water utilities have tended to be less politicized and completed in a more timely manner. The small-capitalization of the water utility group provides a scarcity premium. Finally, the water utility sector offers above-average growth opportunities, given the fragmentation in the sector and ongoing infrastructure investment needs.

Another factor to keep in mind is that water utilities, while long viewed as recession resistant, have not been immune to the recent deep recession. Customer growth has sharply declined with the housing freeze and industrial and commercial water use has also contracted. Leaving aside weather volatility, a rebound in the economy will provide some boost to earnings – and likely to valuation as well.

Adding it all up, we believe investors have an attractive opportunity to initiate or add to positions of Aqua America at current levels. Our \$20 fair value is based on our 2010 outlook, which assumes that company can grow earnings 15% in 2010; even assuming a more a more weather-normalized 2009 performance, 2010 earnings growth would be ~7% under our current forecast, in line with the company's 7-10% historical growth rate. We continue to apply a ~22x P/E multiple to 2010 earnings to generate our fair value, with an assumed EV/EBITDA multiple of 10.4x. Aqua America's earnings potential remains above that of peers that have a more limited geographic footprint. As a result, we believe a modest premium multiple is deserved given the company's growth prospects, operating cost management, and leadership in regulatory management.

With the stock back near late 2008 lows and a dividend yield approaching 4%, we see total return potential of 30% to reach our fair value. We reiterate our BUY rating on Aqua America shares.

Aqua America (WTR)			
	2008	2009E	2010E
Sales (\$ mil)	627.0	672.9	733.3
Price/Sales	3.41x	3.18x	2.92x
O&M/Revenue	41.8%	40.3%	39.5%
EBITDA (\$ mil)	325.4	357.0	396.8
EBITDA growth	4.8%	9.7%	11.2%
Price/EBITDA	6.6x	6.0x	5.4x
EV/EBITDA	10.9x	9.9x	8.9x
EPS	\$0.73	\$0.77	\$0.89
EPS growth	2.2%	6.2%	14.9%
P/E	21.6x	20.4x	17.7x
Dividend	\$0.51	\$0.55	\$0.59
Current Data Points:			
Recent Price	\$15.71		
Current Yield	3.5%		
Market cap	\$2.14 bil		
Total debt	1,397 mil		
Total Debt/cap	56.4%		
Book value/Share	\$7.91		
Price/Book	2.0x		
ROE (TTM)	9.8%		

Source: Baseline, JMS Estimates

THIRD QUARTER RESULTS:

Aqua America reported third quarter earnings of \$0.25, in line with our estimate and consensus. The company reported results of \$0.26 per share in the third quarter last year, which included a \$4.1 million (2 cents in EPS) gain for the sale of an Illinois water system and a \$2.5 million (1 cent) one-time, non-cash charge associated with “truing up” the accounting for the finalized Texas rate case. We believe year-over-year operating results, excluding these one-time items, were flat. Management stated that weather was a three cents drag in the current period. Economic weakness is also a factor, though more difficult to quantify.

Quarterly revenue increased just 2.1%, below our 4% expectation due to the highly uncooperative weather throughout the Mid-Atlantic region. While consumption was up moderately in the southern region, and down only slightly in the Mid-West, consumption in its Northern region (PA, NJ & NJ), which comprises over 60% of Aqua’s customer base, declined 11%. Send-out levels in New Jersey fared the worst, down 19% year-over-year, a steeper consumption decline than we can recall any water utility ever having posted. While we had suspected that some of this decline must be attributable to the loss of a commercial or industrial (C&I) customer, management confirmed that there were no meaningful shifts in its C&I customer base, and the majority of its customer base in the state is residential. It is difficult to decipher the weather vs. economic impact of the decline; however, we believe the lion’s share was weather-related.

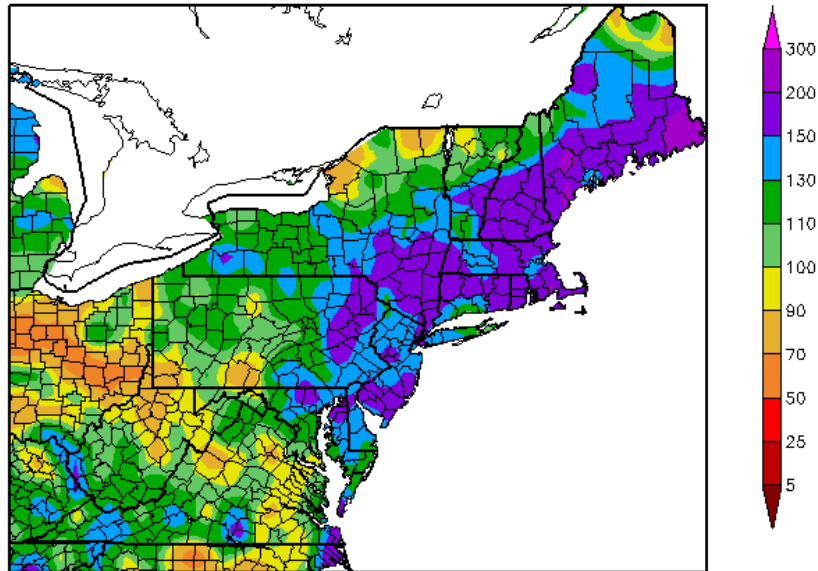
Excluding one time items last year, the company was able to decrease its operating & maintenance costs, achieving an efficiency ratio (O&M/revenue) of 37.9%, 10 basis points better than our estimate. Depreciation costs were also slightly below our estimate, partially offsetting the impact of light revenues relative to our forecast. EBIT of \$72.4 million and net income of \$33.5 million were below our estimates of \$73.7 million and \$34.4 million respectively. Due to the revenue weakness, the company’s trailing-twelve month return on equity dipped back below 10.0%, to 9.8%.

Third Quarter Results				Aqua America, Inc.		
(amounts in millions, except per share data)						
	3Q08	3Q09A	3Q09E	YOY	% Change EST/3Q 09	Act. Vs. Est.
Operating Revenues:	\$177.10	\$180.83	\$184.18	2.1%	4.0%	-1.8%
Operating Expenses:						
Operations and maintenance	66.74	68.49	69.99	2.6%	4.9%	-2.1%
<i>Efficiency ratio</i>	<i>37.7%</i>	<i>37.9%</i>	<i>38.0%</i>			
Depreciation & Amortization	24.63	28.47	30.05	15.6%	22.0%	-5.3%
<i>D&A/Revenue</i>	<i>13.9%</i>	<i>15.7%</i>	<i>16.3%</i>			
General Taxes	11.16	12.42	11.60	11.3%	3.9%	7.1%
Total operating expenses	102.53	109.37	111.64			
Operating Income	74.57	71.46	72.54	-4.2%	-2.7%	-1.5%
AFUDC	0.98	0.75	1.00	-23.8%	2.0%	-25.3%
Gain on sale of non-utility property	0.53	0.16	0.15	-69.4%	-71.7%	8.0%
EBIT	76.08	72.36	73.69	-4.9%	-3.1%	-1.8%
EBIT Margin	43.0%	40.0%	40.0%			
Interest expense	17.01	17.26	16.76	1.4%	-1.5%	3.0%
Income before income taxes	59.07	55.11	56.93	-6.7%	-3.6%	-3.2%
Income tax	23.69	21.64	22.54	-8.7%	-4.9%	-4.0%
<i>Income tax rate</i>	<i>40.1%</i>	<i>39.3%</i>	<i>39.6%</i>			
Net Income	\$35.38	\$33.47	\$34.39	-5.4%	-2.8%	-2.7%
	20.0%	18.5%	18.7%			
Diluted EPS	\$0.26	\$0.25	\$0.25	-6.0%	-3.4%	-2.7%
Diluted shares outstanding	135.40	136.26	136.20	0.6%	0.6%	0.0%

Source: Aqua America & Janney Montgomery Scott estimates

The following chart indicates the weather difficulties experienced by Aqua America, and its northeast peers, during the important summer months. For Aqua, the impact on southeast Pennsylvania was the most important, as that is its largest operating territory. Though it has diversified its operations in the Southeast and Mid-West, Pennsylvania still comprises about 52-53% of its customer base.

Percent of Normal Precipitation (%): June 1 - August 31, 2009



Source: NOAA Regional Climate Center

FORWARD ASSUMPTIONS:

We have made only modest changes to our earnings estimates as we maintain our 2009 estimates of \$0.77 and raise our 2010 estimate by a penny to \$0.89. Our 2009 estimate assumes only 7.3% revenue growth, as wet weather and the difficult economy muted top line performance and masked the benefit from rate increases. Our 2010 revenue assumption of 9.6% year-over-year growth may prove conservative, assuming a return to normal weather. Our estimate also assumes that new rates in Pennsylvania, the company’s largest operating subsidiary, take hold in the third quarter. We expect the company’s 2009 efficiency ratio to reach 40.3%, a 150 basis point improvement over 2008. We expect a further 80 basis point improvement in 2010, as the company achieves an annual efficiency ratio of 39.5%, below the coveted 40% threshold. The company’s efficiency ratio had historically been below 38% but has not been below 40% since the acquisition of AquaSource in 2003. Our 2010 EPS estimate of \$0.89 per share assumes growth of 15.9% above reported 2009 estimates. Earnings growth based off “weather normalized” 2009 EPS, adding adds back the \$0.05-\$0.06 of weather drag this year, is more in the 7-8% growth range.

Long-term, we believe Aqua America’s capital spending program of \$300-\$325 million annually should allow the company to post trend-line earnings growth of 7-10%, barring unusual weather discrepancies similar to what we have experienced this year.

Company Description

Aqua America, Inc. provides water and wastewater utility service to suburban areas outside of Philadelphia, Chicago, and Cleveland, as well as other communities throughout 13 states, including Pennsylvania, New York, Ohio, North Carolina, Illinois, Texas, Florida, New Jersey, Indiana, Virginia, Maine, Missouri, and South Carolina.

IMPORTANT DISCLOSURES

Research Analyst Certification

I, Debra G. Coy and Heike M. Doerr, the Primarily Responsible Analyst for this research report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views I expressed in this research report.

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The research analyst primarily responsible for preparing this research report or a member of the research

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The research analyst is compensated based on, in part, Janney Montgomery Scott's profitability, which includes its investment banking revenues.

Definition of Ratings

BUY: Janney expects that the subject company will appreciate in value. Additionally, we expect that the subject company will outperform comparable companies within its sector.

NEUTRAL: Janney believes that the subject company is fairly valued and will perform in line with comparable companies within its sector. Investors may add to current positions on short-term weakness and sell on strength as the valuations or fundamentals become more or less attractive.

SELL: Janney expects that the subject company will likely decline in value and will underperform comparable companies within its sector.

Price Charts



Janney Montgomery Scott Ratings Distribution as of 9/30/09

Rating	IB Serv./Past 12 Mos.			
	Count	Percent	Count	Percent
BUY [B]	140	49	15	3.50
NEUTRAL [N]	139	49	4	4.14
SELL [S]	5	2.00	0	0.00

***Percentages of each rating category where Janney has performed Investment Banking services over the past 12 months.**

Other Disclosures

Investment opinions are based on each stock's 6-12 month return potential. Our ratings are not based on formal price targets, however our analysts will discuss fair value and/or target price ranges in research reports. Decisions to buy or sell a stock should be based on the investor's investment objectives and risk tolerance and should not rely solely on the rating. Investors should read carefully the entire research report, which provides a more complete discussion of the analyst's views.

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