

AQUA AMERICA INC. (WTR)

2Q11 Quick Read: Results Top Expectations; Shale Gas Water Sales A Likely Driver

Market Data

Current Price (as of 08/02/11):	\$21.05
52 Week Range:	\$18.9-\$23.79
12 Month Target:	\$25
Market Capitalization (MM):	\$2,909
Shares Outstanding (MM):	138.2
Enterprise Value (MM)	\$4,553
Institutional Holdings:	46.8%
Avg Daily Volume (Th):	720.0
Dividend:	\$0.62
Indicated Yield:	2.91%

Capitalization

TBV/ Share	\$8.3
Total Debt / Cap'l:	58.1%

Fundamental Summary

3-Yr. Hist. Rev CAGR:	8.9%
Return on Avg. Equity:	11.0%

EPS	2010	2011E	2012E	2013E
1Q	\$0.16	\$0.18	A	
2Q	\$0.22	\$0.25	A	
3Q	\$0.32	\$0.33	E	
4Q	\$0.21	\$0.23	E	
Annual	\$0.90	\$0.98	\$1.05	\$1.16
Annual	\$0.59	\$0.63	\$0.69	\$0.76
EBITDA (\$M)	\$393	\$421	\$446	\$486

P/E	23.3x	21.4x	20.0x	18.1x
EV/EBITDA	11.6x	10.8x	10.2x	9.4x

Source: CapIQ & Ladenburg Thalmann & Co., Inc.

Note: Excludes one-time items & disc. ops.

Highlights:

- **Aqua America reported adjusted 2Q11 EPS/Revenue of \$0.25/\$188.2MM vs. our \$0.22/\$185.2MM estimate and the consensus \$0.24/\$190.4MM.** Higher than forecast sales and lower than forecast O&M expenses were the key drivers of the better than expected results. The company reported a \$0.025/share benefit due to a non-recurring 2011 Pennsylvania bonus depreciation tax deduction that is excluded from our adjusted results.
- **We believe the modest economic recovery drove a slight increase in industrial water consumption.** Residential consumers however, which account for 50% of total water sold, likely used less water than a year ago, largely due to unfavorable weather comps. Importantly, the weather thus far in 3Q has been exceptionally hot/dry, an indication of strong water sales in the current quarter.
- **We suspect "Other" segment revenue, which includes the non-regulated sale of freshwater to drillers operating in Pennsylvania's Marcellus Shale also contributed to the better than forecast revenue.** Though exact numbers have yet to be disclosed, we believe "Other" segment sales, which had been in decline since 2007, have now grown by over 16% in 3 consecutive quarters. The company continues to enhance its fresh water supply offerings for natural gas drillers in the Marcellus Shale. With drilling activity anticipated to grow geometrically, we believe we are likely in the early stages of the Marcellus business' transformation from the "interesting idea bin" to the "highly material" column, a process that should slowly, but likely play out in coming months and years. We expect financial details on "Other" business activity will be disclosed by the company on this morning's conf. call and in the to-be-filed 10-Q.
- **O&M expenses, reduction of which has been a key strategic focus, rose just 1% vs. our expectations for 3.5% growth, and the 1Q11 pace of 4%.** See page 2 for a complete comparison of actual versus expected results.
- **CapEx of \$74.1MM compared to our expectations for \$68MM, despite a wet spring that likely subdued construction activity.** Our 2011 \$304MM CapEx estimate compares to WTR's \$325MM target. By this point last year, WTR had spent 43% of its 2010 CapEx, and is currently at 44% of our target.
- **As shares have traded down with the broader market in recent weeks, we believe current valuation presents a highly attractive entry point. WTR shares purchased at less than 22x forward earnings have offered a 25% 1-Year return on average over the last 10 years, and have had a positive 1-Year return 93% of the time.** We reiterate our BUY rating and \$25 target. Our target is based on WTR trading at 23.8x our 2012 EPS estimate, in-line with the 10-year avg. FY+2 multiple. (Initiated coverage of WTR on 6/8/11).

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Disclosures and Analyst Certifications can be found in Appendix A.

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Comparison of Actual Vs. Expected 2Q11 Results

	2Q11A	2Q11E	2Q10A	1Q11A	2Q11A vs. 2Q11E	2Q11A vs. 2Q10A	2Q11A vs. 1Q11A
Operating Revenues	\$188.2	\$185.2	\$178.4	\$171.3	2%	5%	10%
O&M Expense - Consolidated	\$70.4	\$71.6	\$69.3	\$69.8	-2%	2%	1%
Property & Other Taxes	\$13.4	\$13.5	\$12.9	\$13.8	-1%	4%	-2%
EBITDA	\$104.3	\$100.0	\$96.2	\$87.8	4%	8%	19%
Operating D&A	\$29.5	\$29.9	\$30.1	\$29.2	-1%	-2%	1%
Operating Income	\$74.8	\$70.1	\$66.1	\$58.5	7%	13%	28%
Interest Expense	(\$20.1)	(\$20.5)	(\$18.5)	(\$19.9)	-2%	9%	1%
AFUDC Income	\$1.9	\$1.0	\$1.5	\$2.0	93%	32%	-2%
Other Income (Expense), Net	\$0.1	\$0.5	\$0.1	\$0.1	-72%	25%	14%
Income Before Taxes	\$56.8	\$51.1	\$49.1	\$40.7	11%	16%	40%
<i>Effective Tax Rate</i>	<i>40%</i>	<i>40%</i>	<i>39%</i>	<i>40%</i>	<i>45 bps</i>	<i>-71 bps</i>	<i>-30 bps</i>
Income Tax Expense	\$22.7	\$20.2	\$19.3	\$16.1	12%	18%	41%
NI Applicable to Common	\$34.1	\$30.9	\$29.9	\$24.6	10%	14%	39%
Other Comprehensive Income, Net	\$0.0	\$0.0	\$0.0	(\$0.0)	NM	NM	-1150%
Comprehensive Income	\$34.1	\$30.9	\$29.9	\$24.6	10%	14%	39%
FD Operating EPS	\$0.25	\$0.22	\$0.22	\$0.18	10%	13%	39%

Source: Company Filings, Ladenburg Thalmann & Co., Inc.

APPENDIX A: IMPORTANT RESEARCH DISCLOSURES**ANALYST CERTIFICATION**

I, Michael Roomberg, attest that the views expressed in this research report accurately reflect my personal views about the subject security and issuer. Furthermore, no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation or views expressed in this research report.

The research analyst(s) primarily responsible for the preparation of this research report have received compensation based upon various factors, including the firm's total revenues, a portion of which is generated by investment banking activities.

COMPANY BACKGROUND

Aqua America, Inc., through its subsidiaries, operates regulated utilities that provide water or wastewater services in the United States. It serves residential, commercial, fire protection, industrial, and other water and wastewater customers in Pennsylvania, Ohio, North Carolina, Illinois, Texas, New Jersey, New York, Florida, Indiana, Virginia, Maine, and Georgia. As of December 31, 2010, it served approximately 3 million customers.

VALUATION METHODOLOGY

We value equities utilizing a multi-faceted approach which includes: sum-of-the-parts, net asset value, discounted cash flow, leading P/E and EV/EBITDA.

RISKS

On top of normal economic and market risk factors that impact most all equities, Aqua America (WTR) is uniquely at risk to:

The outcome of regulatory filings: We expect the company will be among the fastest growing in the water utility peer group in coming years, as WTR's subsidiaries continue to file requests with state Commissions for rate increases in order to achieve rates of return on water assets commensurate with peers. If state Commissions deny these rate requests in whole or in part, it would likely have a negative impact on earnings.

Extreme weather patterns, including drought or prolonged periods of rainfall can impact consumption, and thus revenue of the company.

Product safety: Water is the only utility that is ingested. Though the company has a strong track record with respect to water contaminants, a breakdown in safety procedures could have a markedly negative effect on the company.

Financial Risk: Aqua America is a particularly capital intensive water utility. Though the company has traditionally accessed the credit markets at some of the lowest rates in this industry, this may not be the case going forward. Such a development could negatively affect earnings.

Fort Wayne Litigation – The company was awarded an initial payment in a recent eminent domain proceeding surrounding certain assets in Fort Wayne, Indiana. The final payment is subject to further litigation. If the final payment amount is determined to be less than the initial payment, the company could be forced to make a one-time payment to the municipality.

STOCK RATING DEFINITIONS

Buy: The stock's return is expected to exceed 15% over the next twelve months.

Neutral: The stock's return is expected to be plus or minus 15% over the next twelve months.

Sell: The stock's return is expected to be negative 15% or more over the next twelve months.

Investment Ratings are determined by the ranges described above at the time of initiation of coverage, a change in risk, or a change in target price. At other times, the expected returns may fall outside of these ranges because of price movement and/or volatility. Such interim deviations from specified ranges will be permitted but will become subject to review.

RATINGS DISPERSION AND BANKING RELATIONSHIPS (AS OF 7/31/11)

Buy	76%	(35% are banking clients)
Neutral	24%	(15% are banking clients)
Sell	0%	(0% are banking clients)

OTHER COMPANIES MENTIONED/COMPANY SPECIFIC DISCLOSURES:

None.

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