



AQUA AMERICA INC. (WTR)

American Water Asset Swap Clear Win-Win for Both Companies

Market Data

| | |
|---------------------------------|-----------------|
| Current Price (as of 07/08/11): | \$22.49 |
| 52 Week Range: | \$18.48-\$23.79 |
| 12 Month Target: | \$25 |
| Market Capitalization (MM): | \$3,109 |
| Shares Outstanding (MM): | 138.2 |
| Enterprise Value (MM) | \$4,752 |
| Institutional Holdings: | 47.8% |
| Avg Daily Volume (Th): | 27.0 |
| Dividend: | \$0.62 |
| Indicated Yield: | 2.76% |

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 | \$0.22 | E | |
| 3Q | \$0.32 | \$0.33 | E | |
| 4Q | \$0.21 | \$0.23 | E | |
| Annual | \$0.90 | \$0.96 | \$1.06 | \$1.16 |
| Annual | \$0.59 | \$0.63 | \$0.69 | \$0.76 |
| EBITDA (\$M) | \$393 | \$418 | \$449 | \$485 |
| P/E | 24.9x | 23.5x | 21.2x | 19.4x |
| EV/EBITDA | 12.1x | 11.4x | 10.6x | 9.8x |

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

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

Highlights:

- This morning, Aqua announced two simultaneous transactions in which the company will acquire all of American Water's Ohio regulated water and wastewater assets for \$120 million and American will acquire all of Aqua's New York regulated water utility assets for \$71 million.** The transactions, which subject to regulatory approval are scheduled to close in 1Q12, represent a net addition to Aqua's rate base of ~2% or \$50 million and a net contraction in AWK's rate base of ~0.5%. We expect the deal to be neutral to earnings for both companies in 2012.
- Asset Swaps Consolidate Footprint, Provide Critical Mass:** Today's deal marks the second time the two companies have announced asset swaps in the last 8 months, following a previous deal in which Aqua assumed American's Texas assets in exchange for its Missouri assets, a deal that closed in May 2011. Today's transactions, which will make each water utility the largest in its respective state, allows both companies to 1) streamline their overall operational structure, 2) sharpen focus on strategic growth opportunities in each state, and 3) better leverage existing relationships with regulatory and municipal constituencies.
- For WTR, Acquisitive Rate Base Growth Story Continues:** As a result of the deal, Aqua is poised to add roughly \$50 million net to its rate base at a net cost of \$50 million, in our estimation. Aqua will add roughly 16k customers in a state that is among the more favorable for water utilities, offering an infrastructure surcharge mechanism, forward looking test years, and constructive ROE's. Subsequently, Aqua's rate base in Ohio will now total close to \$250 million. Last month, American filed a \$7.8 million rate request in Ohio, a proceeding that should be finalized by 2Q12. This case is expected to continue under Aqua's new ownership. We believe Aqua was also drawn to prospects for increased water demand in eastern Ohio, where freshwater needed for hydraulic fracturing of the nearby Marcellus Shale is expected to grow exponentially in coming years.
- For American, the swap represents another opportunity to optimize its footprint.** Asset optimization is a key aspect of the company's strategy to lift its lagging consolidated earned ROE, and to that end in the past year, the company has exited its operations in TX, NW, AZ, and OH.
- We reiterate our BUY rating and \$25 price target for WTR shares.** Our target is based on the shares trading at 23.8x our 2012 EPS estimate of \$1.06, in-line with the 10-year avg. FY+2 multiple. Our 2012 EPS est. is \$0.02 below consensus.

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Disclosures and Analyst Certifications can be found in Appendix A.

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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 6/30/11)

| | | |
|---------|-----|---------------------------|
| Buy | 75% | (35% are banking clients) |
| Neutral | 25% | (15% are banking clients) |
| Sell | 0% | (0% are banking clients) |

OTHER COMPANIES MENTIONED/COMPANY SPECIFIC DISCLOSURES:

American Water Works (AWK-\$30.16-NEUTRAL)

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