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**Reports 2Q11; Maintaining Buy Rating, \$29 Target Price**

**Buy**  
**Target Price: \$29**

**Investment Summary** – Aqua America does it again. Despite less-than-stellar weather conditions in 2Q11, WTR managed to make our Street-high \$0.27 EPS estimate (on slightly lower revenues, no less) equating to flat YOY performance. The company also increased its dividend 6.5%; that makes 21 dividend increases in 20 years, and the 65th consecutive year of dividends payments. The accomplishments in 2Q11 are all the more impressive given the asset swaps and sales WTR is/has been transacting with Connecticut Water Service (CTWS \$26.67, Buy) and American Water Works (AWK \$28.29, Buy). We also note that the stage is set for outperformance in 3Q11, given the extremely hot and dry weather conditions not only in the Northeast, but in Texas as well, where WTR has size. We are maintaining our Buy rating and \$29 target price, based on the shares attaining a level of 26x our 2012 EPS estimate of \$1.10.

**Discussion**

- **2Q11 results met expectations.** While revenue in the quarter of \$188.2 million (a 5.5% YoY increase) came in just below our \$193 million estimate, EPS of \$0.27 (core adjusted EPS of \$0.25) matched our Street-high estimate. Net income and cash generation in the quarter were positively impacted by increased sales, cost controls, and the net state tax benefits of \$3.5 million from the 100% bonus depreciation on the company’s capital spending in Pennsylvania, which will continue to positively impact earnings through the remainder of the year. Without the bonus depreciation, net income still grew \$34.1 million from the same quarter last year (14%).
- **O&M expenses up slightly.** O&M expenses in the quarter of \$70.4 million increased just 1.6% from the same quarter last year, which equates to an O&M-to-revenue ratio of just 37.4%, down 140 basis points from 2Q10. WTR management continues to do a great job at stripping out costs of the business model.
- **Rate update.** YTD, Aqua has received rate awards of \$18 million in Pennsylvania, Indiana, and Ohio. Currently, there are \$25 million of rate cases pending before seven state regulatory bodies. The company plans to request an additional \$45 - \$50 million later in 2011, thru the filing of rate cases and infrastructure surcharges in seven states. We expect a positive impact from this activity to materialize in 2012 results.
- **Capex continues.** Through the first six months of the year, Aqua has invested \$134.4 million in infrastructure improvements, and remains on track to invest \$325 million this year, which would be a company record. And this is the first time that cash generation (\$160 million) in the first half of the year exceeded capital spending.

Price	\$21.78
52-Week High/Low	\$23.79 - 18.90
Shares Outstanding (mm)	138.22
Market Cap. (mm)	\$3,010.37
Average Daily Volume (mm)	0.57

EPS	FY10A	FY11E	FY12E
Mar	\$0.16	\$0.19A	\$0.21
Jun	\$0.22	\$0.25A	\$0.27
<i>Prior</i>	-	\$0.23	\$0.27
Sep	\$0.32	\$0.34	\$0.38
<i>Prior</i>	-	\$0.32	\$0.36
Dec	\$0.21	\$0.24	\$0.25
<i>Prior</i>	-	\$0.24	\$0.25
<b>FY</b>	<b>\$0.90</b>	<b>\$1.02</b>	<b>\$1.10</b>
<i>Prior</i>	-	\$0.99	\$1.10
Consensus	-	\$1.03	\$1.06
P/E	24.1x	21.4x	19.7x
FY Rev. (mm)	\$726.07	\$773.48	\$804.18



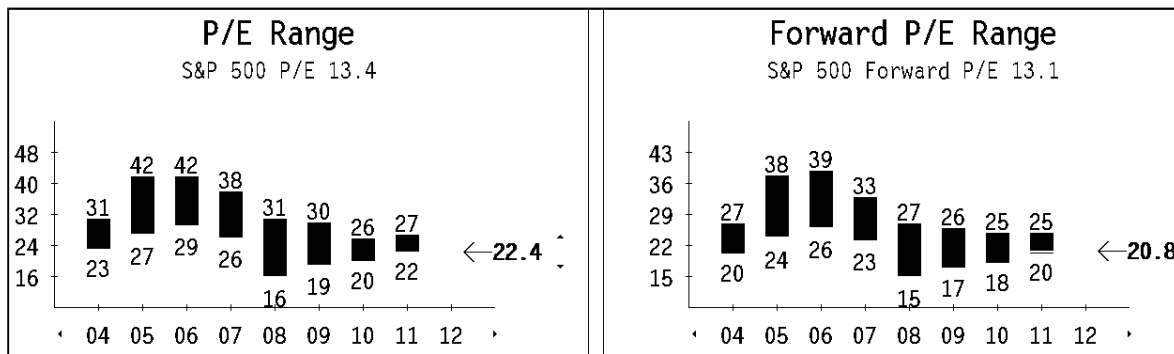
Source: BigCharts.com

**Acquisition update.** On July 11, 2011, Aqua announced an agreement to purchase all of American Water Works’ regulated operations in Ohio, acquiring \$98 million in additional rate base, and simultaneously to sell its New York regulated operations to AWK, which included approximately \$50 million in rate base. The deal is expected to close in 1Q12. And in June Aqua closed its agreement with AWK to purchase their Texas regulated operations while selling them the bulk of their Missouri operations. Most recently, Aqua announced July 27, 2011 an agreement to sell its regulated operations in Maine to CTWS for \$53.5 million. We think Aqua’s ongoing efforts to concentrate more geographically where they obtain more scale is strategically sound, especially in states like Texas and Ohio where the company already has a substantial presence, allowing fixed costs to be spread over more customers. Outside of the aforementioned asset swaps/sales, Aqua has made six acquisitions of water or wastewater systems YTD.

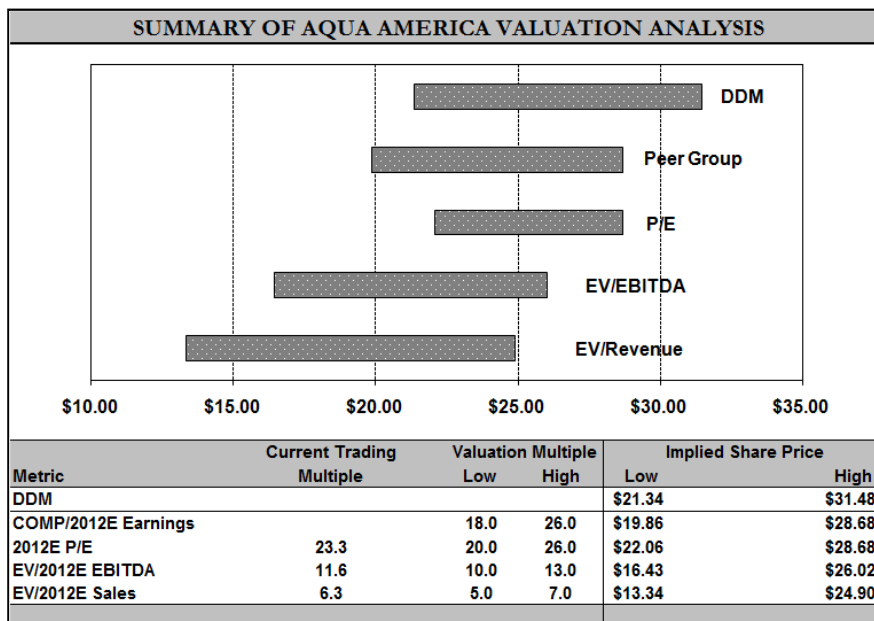
**Adjusting estimates.** After making minor adjustments, we have made the following adjustments to our model: our adjusted (CORE) 2011 EPS estimate is now \$1.02, up from \$0.99, and our 2012 EPS estimate remains unchanged at \$1.10.

**Valuation.** We believe Aqua America is superbly positioned for growth. Its ability to access low-cost capital, as well as its strong internal cash generation and proven track record to acquire new systems and invest prudently in its asset base should continue to drive top and bottom line growth going forward. With the shares now trading at 19.5x our 2012 EPS estimate of \$1.10, we continue to recommend share accumulation. We reiterate our Buy rating and \$29 target price, based on the shares attaining a level of 26x our 2012 EPS estimate of \$1.10. We also note the shares currently yield 3.1%.

Aqua America Trailing and Forward P/E Ratios, 2004 – 2011



Source: Baseline



Source: Company reports, Brean Murray, Carret & Co. estimates

Aqua America		Quarterly Income Statement, 2011E								
(\$000, except per share data)										
Fiscal year ends December 31										
	1Q11	% Rev or Margin	2Q11	% Rev or Margin	3Q11E	% Rev or Margin	4Q11E	% Rev or Margin	2011E	% Rev or Margin
<b>Sales</b>	171,324		188,229		220,265		193,659		773,477	
Operating & maintenance	67,325	39.3%	70,437	37.4%	79,295	36.0%	75,140	38.8%	292,197	37.8%
Depreciation	27,293	15.9%	27,578	14.7%	27,093	12.3%	27,887	14.4%	109,850	14.2%
Amortization	1,956	1.1%	1,931	1.0%	3,304	1.5%	3,292	1.7%	10,483	1.4%
Non-income taxes	13,765	8.0%	13,446	7.1%	14,097	6.4%	13,362	6.9%	54,670	7.1%
<b>Operating income</b>	<b>60,985</b>	<b>35.6%</b>	<b>74,837</b>	<b>39.8%</b>	<b>96,476</b>	<b>43.8%</b>	<b>73,978</b>	<b>38.2%</b>	<b>306,276</b>	<b>39.6%</b>
Interest expense, net	19,943	11.6%	20,106	10.7%	20,485	9.3%	19,947	10.3%	80,481	10.4%
AFC	(1,977)	-1.2%	(1,932)	-1.0%	(1,500)	-0.7%	(1,500)	-0.8%	(6,909)	-0.9%
Gain on sale of other assets	(121)	-0.1%	(138)	-0.1%	(400)	-0.2%	(400)	-0.2%	(1,059)	-0.1%
Income before taxes	43,140	25.2%	56,801	30.2%	77,891	35.4%	55,931	28.9%	233,763	30.2%
Income taxes	12,789	29.6%	19,211	33.8%	27,262	35.0%	19,017	34.0%	78,278	33.5%
<b>Net income</b>	<b>30,351</b>	<b>17.7%</b>	<b>37,590</b>	<b>20.0%</b>	<b>50,629</b>	<b>23.0%</b>	<b>36,914</b>	<b>19.1%</b>	<b>155,485</b>	<b>20.1%</b>
<b>Earnings per share</b>	<b>\$0.22</b>		<b>\$0.27</b>		<b>\$0.32</b>		<b>\$0.26</b>		<b>\$1.13</b>	
<b>Adjusted (CORE) EPS</b>	<b>\$0.19</b>		<b>\$0.25</b>		<b>\$0.34</b>		<b>\$0.24</b>		<b>\$1.02</b>	
Shares outstanding (000)	138,384		138,781		139,081		139,381		138,175	
Aqua America		Quarterly Income Statement, 2012E								
(\$000, except per share data)										
Fiscal year ends December 31										
	1Q12E	% Rev or Margin	2Q12E	% Rev or Margin	3Q12E	% Rev or Margin	4Q12E	% Rev or Margin	2012E	% Rev or Margin
<b>Sales</b>	181,603		197,640		231,278		193,659		804,181	
Operating & maintenance	72,278	39.8%	77,080	39.0%	83,260	36.0%	73,590	38.0%	327,133	40.7%
Depreciation	27,241	15.0%	26,484	13.4%	26,828	11.6%	28,274	14.6%	108,827	13.5%
Amortization	1,816	1.0%	1,976	1.0%	1,850	0.8%	1,743	0.9%	7,386	0.9%
Non-income taxes	13,075	7.2%	12,649	6.4%	13,877	6.0%	13,362	6.9%	52,964	6.6%
<b>Operating income</b>	<b>67,193</b>	<b>37.0%</b>	<b>79,451</b>	<b>40.2%</b>	<b>105,463</b>	<b>45.6%</b>	<b>76,689</b>	<b>39.6%</b>	<b>328,797</b>	<b>40.9%</b>
Interest expense, net	19,976	11.0%	19,369	9.8%	19,659	8.5%	20,722	10.7%	79,725	9.9%
AFC	(1,000)	-0.6%	(1,000)	-0.5%	(1,000)	-0.4%	(1,000)	-0.5%	(4,000)	-0.5%
Gain on sale of other assets	(300)	-0.2%	(300)	-0.2%	(300)	-0.1%	(300)	-0.2%	(1,200)	-0.1%
Income before taxes	48,517	26.7%	61,383	31.1%	87,104	37.7%	57,267	29.6%	254,271	31.6%
Income taxes	19,213	39.6%	24,308	39.6%	34,493	39.6%	22,678	39.6%	100,691	39.6%
<b>Net income</b>	<b>29,304</b>	<b>16.1%</b>	<b>37,075</b>	<b>18.8%</b>	<b>52,611</b>	<b>22.7%</b>	<b>34,590</b>	<b>17.9%</b>	<b>153,580</b>	<b>19.1%</b>
<b>Earnings per share</b>	<b>\$0.21</b>		<b>\$0.27</b>		<b>\$0.38</b>		<b>\$0.25</b>		<b>\$1.10</b>	
Shares outstanding (000)	138,684		139,081		139,381		139,681		139,207	

Source: Company reports, Brean Murray, Carret & Co. estimates

Important Disclosures

Ratings and Target Price History



All prices are as of the market close on 8/3/11.

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Buy - Expected to appreciate by at least 10% within the next 12 months.

Hold - Fully valued, not expected to appreciate or decline materially within the next 12 months.

Sell - Expected to decline by at least 10% within the next 12 months.

	# of Securities	% of Total Securities	# of IB-Related Securities in Past 12 mos.	% of Total Securities
BUY	159	58.89%	19	11.95%
HOLD	74	27.41%	0	0%
SELL	8	2.96%	0	0%
NOT RATED	29	10.74%	3	10.34%
<b>TOTAL</b>	<b>270</b>			

*Note : Stock price volatility may cause temporary non-alignment of some ratings with some target prices.*

### Valuation Methodology and Risks

**American Water Works Co. (AWK):** Our \$38 target price is based on the shares trading at 20x our 2012 EPS estimate of \$1.89. Risks to the achievement of our target price include weather, acquisition integration, regulatory environment, and changes in interest rates.

**Aqua America (WTR):** Our \$29 target price is based on the shares attaining a level of 26x our 2012 EPS estimate. Risks to the achievement of our target price include weather, acquisitions, interest rates, environmental / public health responsibilities and regulatory climate.

**Connecticut Water Service (CTWS):** Our \$30 target price is based on the shares attaining a level of 24x our 2012 EPS estimate of \$1.27. The shares have historically traded within a trailing P/E range of 17-30, and within a forward P/E range of 15-25. Risks to investing in shares of Connecticut Water include, but are not limited to, regulatory concerns, weather, execution risk, natural disasters, access to capital markets, state and federal laws and regulations, information technology reliability, acquisition integration, water supply contamination, and pension requirements.

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We, Michael Gaugler and Christopher Noon, hereby certify that the views expressed in this research report accurately reflect our personal views about any and all of the subject securities or issuers referred to in this document. The analyst and associate analyst further certify that they have not received and will not be receiving direct or indirect compensation in exchange for expressing the recommendation contained in this publication.

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