

RESEARCH NOTE
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Aqua America, Inc. (WTR-\$15.22)
Positive Development in Pennsylvania Rate Case

Company Statistics

Price:	\$15.22
Market Capitalization (M):	\$2,033.8
Average Daily Volume (1-month):	1,240,313
Dividend:	\$0.50
Yield:	3.3%
Rating:	BUY

Financials

FYE Dec	2007E	2008E	2009E	
EPS:	\$0.71	\$0.76	\$0.86	
Prior EPS:	--	--	--	
Quarterly EPS:	Q1	\$0.13	\$0.11	\$0.14
	Q2	\$0.18	\$0.17	\$0.21
	Q3	\$0.22	\$0.27	\$0.29
	Q4	\$0.19	\$0.21	\$0.23
P/E Ratio:	21.4x	20.1x	17.6x	

Research Analyst Certification and Important Disclosures start on page 5 of this document.

INVESTMENT CONCLUSION: We have often heard “value investors” comment that while they understand Aqua’s business model, support its growth strategy and have confidence in the management team, the stock is too rich (on a valuation basis) for them to be buyers. As Aqua touches new 52 week lows at levels not seen since mid-2004, we encourage investors that have been seeking an attractive entry point for this industry leader to consider purchase of Aqua America shares ahead of the earnings strength that we anticipate in the second half of this year and into 2009. Aqua has had some positive developments on the regulatory front, most notably in Pennsylvania, where the Commission yesterday signaled approval of an allowed ROE of 11% in the company’s pending rate case. We acknowledge that 2Q earnings may be light due to unfavorable weather, but with new rate relief we believe Aqua is finally poised for an earnings growth rebound in the second half of this year and in 2009 as well, which should be a catalyst for the shares. We reiterate our BUY rating and \$22 fair value, which assumes appreciation of over 50% from current levels.

KEY POINTS:

- **Positive Development on PA Rate Filing.** At a hearing yesterday, the Pennsylvania Public Utilities Commission (PUC) signaled its intent to approve a \$34.4 million rate increase for Aqua, with an allowed ROE of 11%. In November, the company filed for a \$41.7 million rate increase and an allowed ROE of 11.75%. Recent water rate cases in Pennsylvania have netted “black box” (i.e., undisclosed) ROE rates believed to be in the 10.5% range, so we view yesterday’s decision as a positive development, signaling that the agency understands the need to provide a fair return to support ongoing infrastructure investment.
- **Regulatory Update.** Aqua America continues to diligently work on regulatory matters that should generate a strong earnings rebound in the second half of this year and into 2009. Last Friday, the company received a final decision on its New Jersey rate case. Outstanding rate cases still exist in a variety of jurisdictions including Indiana, Illinois, Ohio, Texas, and Missouri. Additionally, the company has refiled for rate relief in Florida and is expected to file for rate relief in North Carolina shortly. Rate activity, led by the Pennsylvania decision, should generate a strong earnings rebound in the late second half of this year and into next year.
- **Short-term Earnings Risk.** We expect the company to report second quarter earnings of \$0.17, in line with consensus and a penny below results in 2Q07. The key risk to forecast will be the impact of unusually wet weather throughout the MidAtlantic and Midwest regions in the quarter. We believe the additional risk of lower consumption related to economic weakness has already been baked into consensus estimates. In our

view, these risks to second quarter results should not be a reason to keep investors from buying shares of WTR ahead of the company's early August earnings release.

- **Forward Equity Agreement Closed.** In late June, Aqua settled the remaining one million shares of its forward sale agreement with UBS, issuing an additional one million shares to complete the physical settlement. This agreement, unusual for water utilities, was established in August of 2006 and included 3.5 million shares, with settlement dates at the company's discretion but no later than August 2008. The company received cash proceeds of roughly \$11 million on past portions that were settled by cash earlier this year and credited to stockholders' equity. While the company profited from this arrangement, due to the agreement being made at the August 2006 level of around \$21-\$23 and shares settled at levels below \$19, we do not believe the company will use this method of equity accumulation going forward. We have not baked the additional one million shares into our model, but will do so once the company issues forward guidance.
- **Earnings Growth Rebound.** Our estimate for 2008 is currently \$0.76, implying 6% EPS growth, and \$0.86 for 2009, implying 14% growth, a significant improvement after two years of flat growth in 2006 and 2007. We will adjust our estimates to account for the rate cases and the additional equity issuance after the company reports 2Q earnings in a couple of weeks, but at this point, we think there could be some upside to our 2009 forecast. Taking the longer-term view, we remind investors that Aqua America has expanded its asset base by more than 35% over the past four years, through a combination of acquisitions and capital investment. While it has taken longer than hoped to earn adequate returns on these investments, we believe the company is finally in position to generate the returns and the earnings growth that investors have been waiting for.

VALUATION SUMMARY:

The first half of 2008 has been a trying time for Aqua America shareholders, as the stock has dropped 30% since January compared to the average 20% slide the other multi-state water utilities have experienced. Valuations across the group have contracted since last September; however, Aqua has pulled back more than its peers, as investors have lost patience with consecutive years of flat earnings. We expect this to turn around as rate relief takes effect through the second half of 2008 into 2009, and we encourage investors to take advantage of the opportunity to buy into this quality name at discount levels.

For a stock that has always traded at a premium to peers, current levels appear to offer the attractive entry point many investors have been waiting for, as the stock is now trading at the low end of its valuation range over the past five years.

Compared to the other large water utilities, Aqua trades at 17.6x our 2009 estimate, below the group average of 18x. The company is also currently cheaper on an EV/EBITDA basis, trading at 8.4x 2009 estimates, compared to 8.6x for peers.

Our \$22 fair value implies a historical group average P/E multiple of ~25x our 2009 estimate and an EV/EBITDA multiple of 10.9x, below the company's five-year historical average. This suggests a potential total return of about 50% from current levels and is predicated on our view that the water utility group will trend back up toward its median valuation in the coming year. While we don't expect Aqua America to reach its 2006 valuation peak any time soon, if ever, we believe the stock is currently well over-sold and should recover as earnings finally show positive comparisons in coming quarters.

<i>Valuation - Aqua America (WTR)</i>			
	<u>2007</u>	<u>2008E</u>	<u>2009E</u>
Sales (\$ mil)	602.5	642.7	697.0
Price/Sales	3.38x	3.16x	2.92x
O&M/Revenue	42.0%	41.6%	40.4%
EBITDA (\$ mil)	310.5	332.0	368.2
EBITDA growth	8.7%	6.9%	10.9%
Price/EBITDA	6.6x	6.1x	5.5x
EV/EBITDA	10.0x	9.4x	8.4x
EPS	\$0.71	\$0.76	\$0.86
EPS growth	2.0%	6.3%	14.3%
P/E	21.4x	20.1x	17.6x
Dividend	0.47	0.51	0.53
Current Yield	3.1%		
Current Data Points:			
Book value/Share	\$6.95		
Price/Book	2.2x		
ROE (TTM)	10.0%		
Recent Price	\$15.22		
Market cap	\$2.03 bil		
Net debt	\$1,075 mil		

Source: Baseline, JMS Estimates

POSITIVE DEVELOPMENTS IN PENNSYLVANIA

Favorable Allowed ROE Granted in Pennsylvania Rate Case. Pennsylvania is Aqua’s largest operating territory, comprising 44% of the company’s customers and 56% of its total PPE (property, plant and equipment). The company filed for a \$41.7 million rate increase last November with a requested allowed ROE of 11.75%. Yesterday, the Pennsylvania PUC issued a press release regarding Aqua’s rate case. The Commission conducted a “binding poll”, which is used by the PUC Staff to draft the Order, and indicated that the rate increase to be granted by the Commission would be approximately \$34.4 million. At yesterday’s hearing, the four Commissioners unanimously supported an allowed ROE of 11%. ***We are encouraged by this ROE announcement as it indicates that the Pennsylvania Commission is aware of the increased risks faced by water utility companies and supports allowing them to earn a commensurate return for this risk.***

As part of the regulatory process, the Administrative Law Judge (ALJ) assigned to the Aqua case had given his recommendation earlier this month. In making its decision, the Commission takes into account the ALJ opinion along with testimony from various parties involved in the case. The ALJ decision had recommended an increase of \$40.2 million, and had included language that was supportive of Aqua’s mechanism of calculating an allowed ROE. We had suspected the allowed ROE would be higher than the 10.5% that has become standard for water utilities in the state, but had not expected a level higher than 10.8%.

Pennsylvania has long been a trail-blazing Commission creating favorable regulatory mechanisms that encourage infrastructure investment to be made within the state. While the Order has not been finalized, we are confident that the Final Order, expected in August, will be in line with yesterday’s announcement, offering some upside to our current forecast, which had assumed a somewhat lower ROE and revenue contribution.

New Commissioners Expected in PA. Governor Rendell recently announced his nominations to fill two open seats on the Pennsylvania Public Utility Commission, pending approval by the Senate later this year. While the risk exists that the new Commissioners may take a different view on water utility regulation, we do not currently anticipate a meaningful policy change as a result of these appointments. Regulatory treatment in Pennsylvania has been very consistent and progressive over the past decade, a trend we expect to continue.

RATE ACTIVITY CONTINUES TO BE FOCUS

Final Decision in New Jersey. The company reached a settlement agreement with the New Jersey Board of Public Utilities (BPU) last week on its \$6.87 million rate request. The company was granted a \$4.1 million (16.4%) revenue increase with an allowed return on equity of 10%. This allowed ROE is inline with recent allowances in the state, but remains at the low end of the national range. About 5% of Aqua’s customers and asset base are located in New Jersey.

Unfortunately, the Commission opted not to address the company’s request for a DSIC (distribution system improvement charge) mechanism. New Jersey is the last remaining MidAtlantic state to adopt this regulatory mechanism, which allows water utilities to minimize regulatory lag by earning a return on replacement capital investment in between rate cases. We understand that the mechanism has getting increased support within the BPU and are hopeful that the DSIC request filed by American Water in May is the request that finally breaks through the regulatory barriers. Once the first DSIC mechanism is granted, it should be easier for the remaining water utilities in the state to implement something similar, although each will likely need to file a separate request.

Florida Rate Case Filed: In May, Aqua refiled its rate request in Florida for relief comparable in size to the prior case (\$7 million). As a reminder, the company “voluntarily dismissed” its \$7.3 million rate case in August 2007, due to customer opposition and a lack of support from the Public Service Commission. It had been the first rate filing since Aqua acquired the systems from AquaSource and Florida Water Services in 2003 and 2004 and the first rate increase that some customers had seen in a decade. The complexity of the case (80 separate rate filings in 15 counties) paired with a poor operating history prior to Aqua’s ownership and a political shift within the commission contributed to failure of the request. Aqua absorbed \$2.6 million in filing costs in the third quarter of 2007 and returned about \$1 million in previously collected interim rates back to customers. The company has since made

strides to enhance customer relations by improving its call center and hosting a series of “town meetings” and has worked closely with the commission to formulate its new rate request.

Florida has been one of the more challenging operating environments for Aqua America. The historic poor performance of the acquired systems has been an issue since the commission took a distinct pro-consumer shift, with the addition of two new Commissioners last year, putting more pressure on utility businesses in the state. Vocal consumer opposition and unfavorable comments from the Attorney General are likely to repeat themselves as the rate process gets underway. The company is currently earnings less than a 5% ROE in the state, and should the Commission drag on this rate process again or grant a sub-par allowed return on equity (less than 10%), we believe the company would be hard pressed to allocate additional infrastructural dollars to an uncooperative market.

We would not expect a decision before early next year. Although the case is likely to face some headline risk, Florida is a small part of Aqua’s overall asset base, representing only 2.5% of total property, plant and equipment in 2007.

Filing Expected in North Carolina. On the first quarter conference call, Aqua mentioned intentions to file for rate relief in North Carolina. We have not seen a rate filing yet, but would expect the company to file ahead of the next earnings release. In 2007, North Carolina became the company’s second largest state on an assets basis, at 7.5% of total PP&E or \$214 million, overtaking Illinois and Ohio. Nine percent of Aqua’s customers are based in North Carolina.

Since the acquisition of AquaSource in 2003 and Heater Utilities in 2004, the company has invested a considerable amount of capital in the state to resolve environmental compliance issues. The 3-year CAGR of PP&E in North Carolina is ~21%, compared to company-wide CAGR of 10%. It comes as no surprise that rate base growth has been considerably outpacing revenue growth over the past two years as the company made these investments. PP&E increased ~30% and ~17%, compared to revenue increases of just ~10% and ~8%, in 2007 and 2006, respectively. Revenue growth will naturally follow as rate requests are granted to recoup capital investments.

Outstanding Rate Cases in a Handful of States. Aqua has rate cases of approximately \$15 million outstanding in a variety of states including five cases in Illinois totaling \$4 million, a \$3.2 million case in Ohio, a \$2.2 million case in Sarasota, FL (a separate filing from the aforementioned FL filing), and a handful of smaller cases in New York and Indiana. We expect the company to give a detailed update on its pending regulatory matters on the second quarter conference call in early August.

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**

Each of the primarily responsible analysts for this research report, Debra G. Coy and Heike M. Doerr, certify that all the views in this research report accurately reflect her personal views about any and all of the subject securities or issuers. No part of her compensation was, is, or will be directly or indirectly, related to the specific recommendations or views expressed in this research report.

Janney Montgomery Scott LLC Equity Research Disclosure Legend July 18, 2008

Company	Disclosure(s)
Aqua America, Inc. (WTR)	2,7,8

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- 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.
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Price Charts**Janney Montgomery Scott Ratings Distribution as of June 30, 2008***

<u>BUY</u>	<u>NEUTRAL</u>	<u>SELL</u>
43%	51%	2%

*As a percent of total coverage. See ratings definition above.

Janney Montgomery Scott Ratings of Investment Banking Relationships as of June 30, 2008**

<u>BUY</u>	<u>NEUTRAL</u>	<u>SELL</u>
4%	6%	0%

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

Other Disclosures

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