

Research

Summary:

Hera SpA

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Table Of Contents

Rationale

Outlook

S&P Global Ratings' Base-Case Scenario

Business Risk

Financial Risk

Liquidity

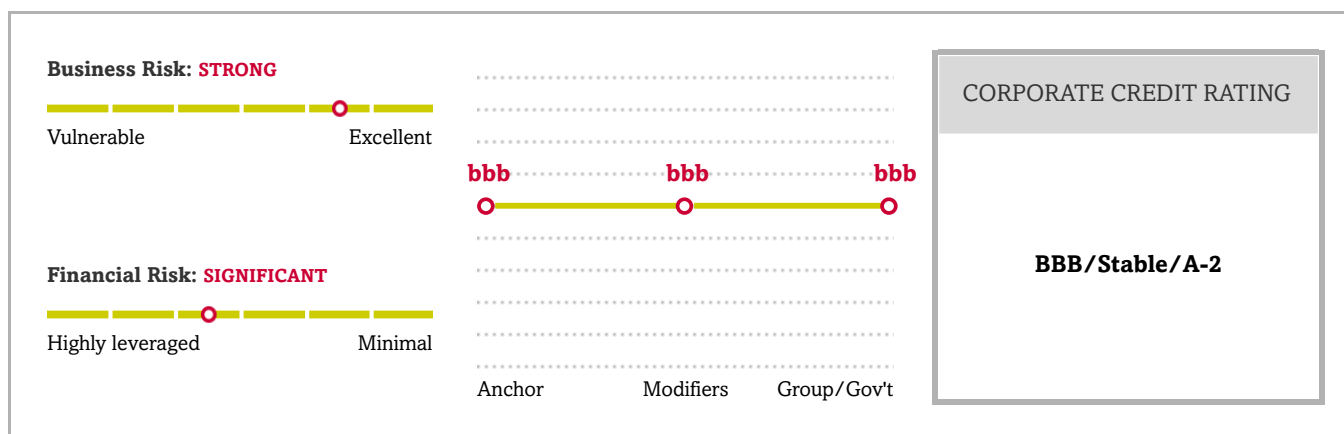
Rating Above The Sovereign

Ratings Score Snapshot

Related Criteria And Research

Summary:

Hera SpA



Rationale

Business Risk

- Increasing share of low-risk regulated activities, exceeding 50% of EBITDA over our 2016-2019 rating horizon, linked to the expectation of regulatory intervention on waste collection.
- Dominant position in northeast Italy in waste and water management and a leading position among domestic energy suppliers (mainly gas).
- Highly acquisitive growth strategy, but only a minor impact on debt.
- Lackluster economic environment and adverse regulatory decisions weighing on organic growth.

Financial Risk

- Neutral cash flow after investments and dividends (before acquisitions).
- Stable dividend policy.

Outlook

The stable outlook on Italian multi-utility Hera SpA reflects S&P Global Ratings' expectation that the company will achieve and sustain adjusted funds from operations (FFO) to adjusted debt of 18%, which we see as commensurate with Hera's significant financial risk profile. The outlook also reflects our view that the Republic of Italy (unsolicited BBB-/Stable/A-3) does not fully constrain Hera's creditworthiness at the current rating level.

Downside scenario

We could lower our ratings on Hera if we considered that it could struggle to achieve and maintain adjusted FFO to debt of about 18% over the next 24 months. This could occur if Italy's market and industry conditions do not recover, jeopardizing Hera's commitment to maintaining at least neutral cash flow generation after capital expenditures (capex) and dividends. We would also lower our ratings on Hera if we lowered our sovereign ratings on Italy by more than one notch, given that the company's exposure to country risk in Italy is high.

Upside scenario

We could take a positive rating action if Hera's financial risk profile strengthened beyond our expectations. A sustainable adjusted FFO-to-debt ratio of about 23% is commensurate with a higher rating, assuming no further change in the rating on Italy or in our assessment of Hera's business risk.

S&P Global Ratings' Base-Case Scenario

Assumptions

- Average revenue growth of 2% over 2016-2018.
- Compound annual growth rate in EBITDA of 2% in 2016-2018.
- Cumulative capex of slightly less than €1.4 billion in 2016-2018.
- Dividends amounting to approximately 80% of free operating cash flow in 2016-2018.

Key Metrics

| | 2015a | 2016e | 2017e | 2018e |
|------------------------|-------|---------|-----------|-----------|
| Adjusted FFO/debt (%)* | 19.0 | 18-18.5 | 18.3-18.8 | 18.3-18.8 |
| Debt to EBITDA (x)* | 3.7 | 3.6-4.0 | 3.6-4.0 | 3.5-3.8 |

*Fully S&P Global Ratings-adjusted. a--Actual. e--Estimate. FFO--Funds from operations.

Business Risk

We base our assessment of Hera's strong business risk profile on its diversified portfolio of utility businesses in one of Italy's wealthiest regions and its dominant local market position. The company operates stable and regulated businesses--water, electricity, and gas distribution--under long-term concessions that are remunerated based on tariffs established by the national regulatory authority (AEEGSI). These activities generate slightly more than 50% of Hera's EBITDA and could increase their contribution over 2016-2018, depending on the outcome of the current gas-distribution retendering process.

We expect acquisitions will remain Hera's growth engine in the low growth economic environment we see in Italy over the next few years. After its two material merger and acquisition (M&A) transactions in 2013-2014, Hera has more recently acquired single assets, mainly in the environmental area. The consolidation of small multi-utilities could become more competitive because Hera's competitors have become increasingly aggressive in consolidating local players. Hera's acquisitive strategy is not detrimental to the rating as long as it continues to finance sizable transactions through share swaps. Hera's proven skills in integrating new businesses and extracting cost synergies is supportive of the business risk profile and enables the company to mitigate the impact of volatile market conditions and adverse regulatory decisions. The prospect of the imminent regulation of waste collection operations by the national regulator for power, gas, and water (AEEGSI) contribute to our view of Hera's strong business risk profile.

Hera's strengths are partly offset by its almost exclusive exposure to country risk in Italy. Relative to European peers, particularly Austrian multi-utilities, Hera faces markedly higher tax pressure, and to a minor extent, higher funding costs.

We think Hera's profitability will remain under pressure owing to the sluggish economic conditions in Italy, coupled with the impact of adverse, albeit less than expected, regulatory decisions for 2016-2018, and increasing competitiveness in liberalized businesses. In our view, the ensuing negative impact on the company's credit metrics will be only partly mitigated by its efforts to cut costs.

S&P Global Ratings' Base-Case Operating Scenario

We expect Hera will generate the bulk of its earnings growth over our rating horizon from networks, and to a lesser extent, from environmental operations. We no longer reflect the acquisition of local multi-utility AIMAG (in which Hera holds a 25% stake) in our base-case scenario as we believe that it is less likely to occur over the next three years.

Financial Risk

Our assessment of Hera's financial risk profile as significant reflects our view of the company's credit metrics. Specifically, we anticipate adjusted FFO to debt in the 18%-19% range over 2016-2018 and adjusted debt to EBITDA below 4x, levels that we see as commensurate with our current rating on Hera.

In our base-case scenario, we forecast that Hera will continue posting neutral-to-positive cash flow after capex and dividends, over the next three years, before acquisitions. Despite the unfavorable environment, Hera's prudent debt management, good access to the bond market, strong liquidity, and a good degree of cash flow predictability, determined by the high and potentially increasing share of regulated business in Hera's portfolio, underpins our expectation of financial stability.

S&P Global Ratings' Base-Case Cash Flow And Capital Structure Scenario

- Generally low EBITDA growth in 2016-2018.
- Dividends exceeding €450 million in 2016-2018.
- Average cost of debt of 3.9% in the same period.

Liquidity

Our short-term rating on Hera is 'A-2'. We assess its liquidity as strong. In our view, the company's planned cash outlays--mainly capex, debt service, and dividends--will be covered by available cash, committed credit lines with maturities exceeding by more than 1.5x over the 12 months started June 30, 2016, and will remain above 1.0x over the following 12 months.

Principal Liquidity Sources:

- Access to unrestricted cash of more than €248 million on June 30, 2016;
- Available undrawn committed credit lines of €445 million as of June 30, 2016 with maturities exceeding 12 months; and
- Our forecast that Hera will generate cash FFO of more than €630 million in the next 12 months.

Principal Liquidity Uses:

- Capex of €300 million;
- Dividend outflows of approximately €150 million; and
- Debt maturities exceeding €170 million over the next 12 months.

Hera enjoys high standing in the credit markets. It was among the first European utilities to issue a 10-year green bond at competitive fixed costs of 2%. Hera's relationships with banks, including with the European Investment Bank, are sound.

Rating Above The Sovereign

We believe there is a reasonable likelihood that Hera would be able to withstand a sovereign default. We have stress-tested Hera's business risk and financial risk profiles in a hypothetical default scenario for Italy. We think that Hera's ability to service and repay debt is superior to that of the Italian government. Consequently, we rate Hera one notch above our 'BBB-' sovereign rating on Italy.

Ratings Score Snapshot

Corporate Credit Rating

BBB/Stable/A-2

Business risk: Strong

- **Country risk:** Moderately high
- **Industry risk:** Low
- **Competitive position:** Strong

Financial risk: Significant

- **Cash flow/Leverage:** Significant

Anchor: bbb

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Stand-alone credit profile : bbb

- **Group credit profile:** bbb
- **Related government rating:** BBB-

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Ratings Above The Sovereign—Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Business And Financial Risk Matrix

| Business Risk Profile | Financial Risk Profile | | | | | |
|-----------------------|------------------------|--------|--------------|-------------|------------|------------------|
| | Minimal | Modest | Intermediate | Significant | Aggressive | Highly leveraged |
| Excellent | aaa/aa+ | aa | a+/a | a- | bbb | bbb-/bb+ |
| Strong | aa/aa- | a+/a | a-/bbb+ | bbb | bb+ | bb |
| Satisfactory | a/a- | bbb+ | bbb/bbb- | bbb-/bb+ | bb | b+ |
| Fair | bbb/bbb- | bbb- | bb+ | bb | bb- | b |
| Weak | bb+ | bb+ | bb | bb- | b+ | b/b- |
| Vulnerable | bb- | bb- | bb-/b+ | b+ | b | b- |

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