S&P Global
Ratings

RatingsDirect®

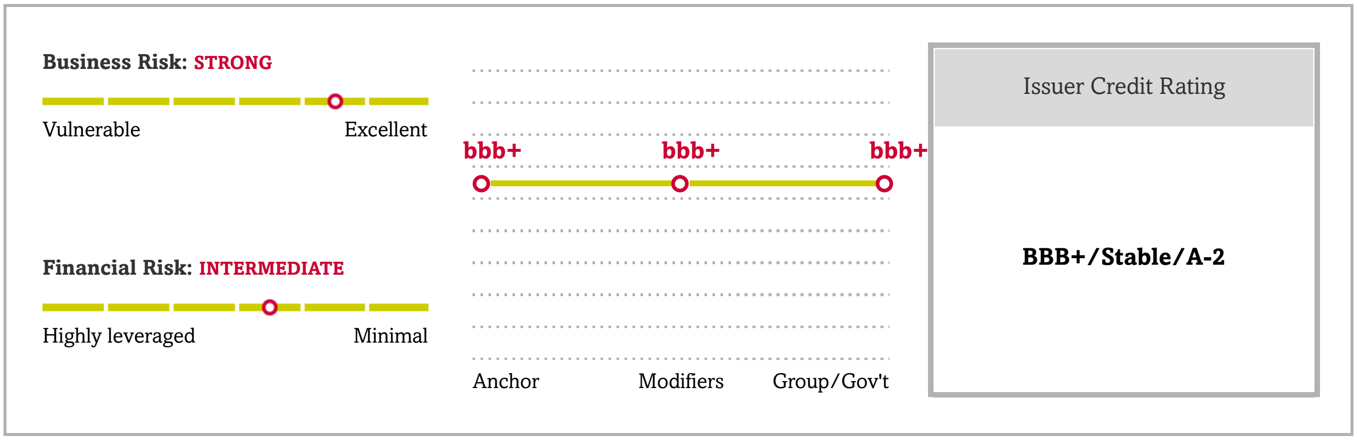
Hera SpA

Primary Credit Analyst:
Federico Loreti, Paris + 33140752509; federico.loreti@spglobal.com

Secondary Contacts:
Massimo Schiavo, Paris + 33 14 420 6718; Massimo.Schiavo@spglobal.com
Claire Mauduit-Le Clercq, Paris + 33 14 420 7201; claire.mauduit@spglobal.com

Table Of Contents

Hera SpA



Credit Highlights

Overview

Key strengths	Key risks
Stable and predictable cash flow generation from fully regulated activities in electricity, gas, water distribution, and urban waste collection and treatment, together representing close to 50% of EBITDA over 2022-2024.	Exposure to Italy--a default of Italy would affect the company's capacity to finance itself.
Dominant position in northeastern Italy in waste and water management, and a leading position among domestic energy suppliers (mainly gas).	Heightened risk of extreme gas supply events and political intervention in a context of persistently high and volatile commodity prices, notably in its gas retail business (21% of 2021 EBITDA). As a partial mitigant, Hera has a diversified portfolio of activities.
Sound financial policy with a strong commitment to the current rating with enough headroom over 2022-2025, with strong 2021 results being a supportive starting point.	Acquisitive growth strategy, though credit-friendly, with limited debt financing and share swaps.

Hera entered the current energy crisis with enough rating headroom thanks to stronger than expected results in 2021. The multi-utility company posted very strong results in 2021, with EBITDA growing by more than €100 million versus 2020, to €1,224 million, the most significant increase in its history. This was mainly thanks to the performance in the waste and energy and energy services segments, while networks were stable year-on-year (yoy). Investments stood at €666 million, of which €96 million related to merger and acquisition activity. Net reported debt was almost flat yoy thanks to healthy cash flow generation which more than covered dividends for about €200 million. Thanks to these strong results, S&P Global Ratings-adjusted funds from operations (FFO) to debt was at 27.9% in 2021, which increases to 28.8% when we include income from last resort clients (€28.1 million in 2021). This metric compares well with the 23% recorded in 2020 (23.9% when including income from last-resort clients) and to our expectation of 25.5%-26.5%, mainly due to strong performance in the final quarter of the year and to a better net debt position. FFO to debt for 2021 is also well above our 23% requirement for the current rating level, which should provide some headroom for the potentially challenging year ahead. Income from last-resort clients is derived from interest on delayed payments from public administration authorities in Italy and is usually material for Hera given its dominant position in the last resort and safeguard markets in both power and gas across the country.

We do not include this financial income in our adjusted FFO under our methodology, but we do look at an additional set of metrics. We note however that this income source is set to decline to below €15 million by 2024 from around €30 million historically, because of a lower volume of clients in the last-resort services market. We therefore expect the difference between these alternative metrics and our base case to decrease to 30 basis points (BPS)-40 bps from 80bps-100 bps historically (see chart 1).

Hera is not exposed to Russian long-term contracted gas, and its procurement strategy and diversified business mix partially offset potential supply disruptions. While this is not our base case, Italy is one of the most exposed countries in Western Europe to a sudden stop of supply of Russian gas, which represents around 40% or about 19 billion cubic meters of gas of total gas imports in a country where gas still accounts for half of the total generation mix. Even though the government is taking action to diversify national gas imports, Hera, as a domestic multi-utility, is exposed to negative event risk directly for around 33% of its 2021 EBITDA (mostly in gas retail, which represented 21% of 2021 EBITDA). That said, we note that Hera has a rather diversified gas procurement portfolio and no long-term contracts with Gazprom. Furthermore, Hera's multiutility business mix allows it to diversify its exposure and offset downside risk compared with pure retailers or generators. In addition, Hera's liquidity with €480 million of available committed credit lines until 2027 should absorb volatility in trading activities (less than 2% of total EBITDA) and in working capital movements. Compared with other fully integrated Italian multiutilities, Hera lacks vertical integration. As such, it may not be able to fully pass through most of the increase in commodity prices to its large retail portfolio (3.5 million customers), in case of persistent detrimental government measures to offset the energy bill increase. That said, we note that Hera has a relatively high share of variable price offers for its customers, which allows it to keep margins at a sustainable level.

In the unlikely scenario of a complete halt of Russian gas, we believe that European governments will step in to prevent systemic risk. In a gas curtailment scenario, which we still view as possible but unlikely, we anticipate a wide effect on the utilities sector as a whole and on Hera as an Italian domestic utility. This includes the use of force-majeure clauses in distribution and retail contracts; state measures to tax windfall profits to contain unsustainable energy bills; and most likely adverse macroeconomic impacts. Therefore, we expect state intervention will supersede Hera's contractual engagements for all physical gas deliveries. Even though this could significantly hit the company, we expect downside to remain manageable, although it is difficult to predict.

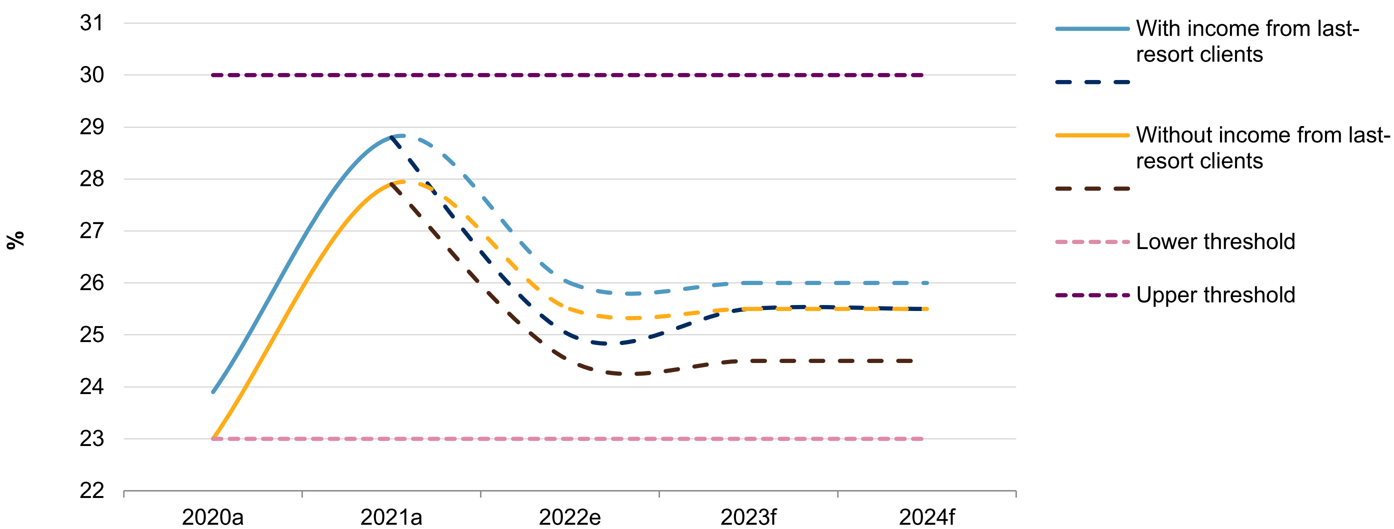
While impact from government measures is manageable for now, we should expect more volatility and additional intervention going forward. The Italian government has introduced a series of measures worth more than €20 billion since October last year, with the aim to limit energy bill increases for companies and households. The most relevant one, the so-called Decreto Tagliaprezzi, plans to introduce an extraordinary levy of 25% on the first margin realized in the seven months ended on April 30, 2022 versus the same period last year. We estimate the impact for Hera on this year's net income should be contained at around €10 million. At the same time, the government also enabled customers to pay their energy bills for the months of May and June in up to 24 instalments, on top of the suspension of system charges charged to the final customers. This, together with general volatility in prices, should translate into a negative working capital swing this year of about €250 million, which will be gradually reabsorbed over the coming years. High commodity prices could also translate into some additional bad debt, even though we note that during the COVID-19 pandemic, Hera's retail portfolio proved resilient, with the unpaid ratio increasing by only 14 bps compared with 2019, with the level in 2021 already below the 2019 statistic. In our base-case scenario, we do not expect a material deterioration of Hera's bad debt.

Organic and inorganic growth and strong cash flow will translate into credit metrics well in line with the requirements for the current rating level over 2022-2024 despite increasing investments. Under its updated strategic plan to 2025, Hera plans to invest an aggregate of €3.8 billion (including capex in 2021), which translates into €768 million annual average investments, 59% higher than in the previous five years. We expect a strong EBITDA increase over the period to offset the spending, led primarily by the retail and waste businesses, which together will add about €180 million in 2025 compared to their EBITDA in 2021. This, combined with a growing regulated asset base (RAB) from regulated businesses and growth in merchant activities, will support Hera's adjusted EBITDA above €1.2 billion by 2024.

Therefore, we expect adjusted FFO to debt (including income from last-resort clients) will consistently hover at about 26% over 2022-2024. As a result of the higher investments, adjusted debt should increase by about €750 million by 2024. Nevertheless, we project that leverage will remain under control at 3.2x-3.3x, thanks to stronger EBITDA growth and healthy operating cash flow.

Chart 1

FFO-To-Debt Evolution With And Without Income From Last-Resort Clients
2020a-2025f



a--Actual. e--Estimate. f--Forecast. Source: S&P Global Ratings.

Hera's strengths are partly offset by its exclusive exposure to Italy, leading us to cap our rating at one notch above that on Italy. We note that Hera's profitability has proven very resilient to the economic context in Italy in the past. However, as a fully domestic utility, we think that a sovereign default would limit Hera's capacity to finance itself. Despite Hera's strong positioning and brand reputation, its sole exposure to Italy remains a risk that we capture by limiting our long-term issuer credit rating to one notch above the Italian sovereign (unsolicited, BBB/Positive/A-2). That said, we also view the Italian framework for regulated activities, which applies to almost half of Hera's EBITDA, as providing a strong regulatory advantage in our view and shields the company from inflation, volume, and counterparty risk (for more details, see "Italian Electricity And Gas Transmission And Distribution Frameworks: Supportive," published on Jan. 20, 2021 and "Italian Water Distribution Framework: Supportive", Feb. 22, 2022).

Outlook: Stable

The stable outlook reflects our expectation that the Italian multiutility Hera will maintain adjusted FFO to debt (including income from last-resort clients) well above 23% over 2022-2024. We also take into account management's commitment to the 'BBB+' rating, with our understanding the company is willing to adjust its financial policy should credit metrics deteriorate close to the rating thresholds. Our stable outlook also factors in no material deterioration of the current macroeconomic and operating environment due to the current geopolitical tensions and the related energy and commodity markets volatility.

Downside scenario

We could downgrade Hera if FFO to debt (including income from last-resort clients) falls below 23% over a prolonged period. This could happen if:

- Hera undertakes larger cash acquisitions or increases its dividend, deviating from what we view as a prudent financial policy;
- Hera does not successfully implement its strategic plan until 2025; or
- Significant unexpected changes in the regulatory framework for Hera's network business (water, gas, electricity and urban waste collection and treatment) impede its ability to achieve EBITDA targets.

Rating downside could occur if Italy's economic environment turns more negative or in case of severe disruptions to gas supply and energy markets, thereby constraining Hera's growth strategy and EBITDA. We would also revise the outlook to negative if we took a similar action on Italy, because we cap our rating on Hera at one notch above the sovereign rating.

Upside scenario

Although unlikely in the short term, we could revise upward our stand-alone credit profile for Hera if it strengthens its credit metrics and achieves adjusted FFO to debt (including income from last-resort clients) at or above 30% on a sustainable basis.

An upgrade of Hera would also depend on our unsolicited rating on Italy.

Our Base-Case Scenario

Assumptions

In our base case for 2022-2024, we assume:

- GDP growth has only a limited effect on Hera as a large share of its revenue is derived from long-term contracted or regulated activities. That said, we expect real GDP growth will be 3.1% in 2022 in Italy, 2.1% in 2023, and 1.5% in 2024.
- Contained profit and loss impact from the measures introduced by the Italian government to limit energy bills, which we estimate at around €10 million in 2022.
- Adjusted EBITDA increases by about 2.3% on average, reaching above €1.2 billion by 2024.
- A stable adjusted EBITDA margin hovering at about 10.5%.
- Income from last-resort clients decreasing from about €30 million in 2021 to below €15 million in 2024.
- Cash taxes above €140 million annually.
- Negative swing in working capital of around €250 million this year as a result of government measures allowing retail customers to pay their bills in instalments. We then expect a gradual reabsorption to a positive cash inflow in 2024.
- Annual capex (including gas tenders) of around €800 million on average, up from about €500 million-€600 million in 2020 and 2021.
- Cash acquisitions of around €250 million in aggregate over the period.
- A stable average cash dividend distribution of €240 million annually, in line with the payout ratio communicated to the market.
- Net reported debt (gross financial debt netted of cash) increasing to around €3.0 billion in 2024 from €2.3 billion as of end-2021.
- Put options on minority stakes (mainly Ascopiave) increasing to above €470 million in 2024 from €447 million at end-2021.

Key metrics

Hera SpA--Key Metrics*

(Mil. €)	2020a	2021a	2022e	2023f	2024f
EBITDA	1,038.9	119.5	1120-1150	1130-1160	1180-1220
Capital expenditure	511.7	594.0	810-830	770-790	760-780
Debt§	3,441.6	3,189.0	3650-3750	3600-3800	3800-4000
Dividends	163.3	193.0	220-230	240-260	250-270
Debt to EBITDA (x)	3.3	2.8	3.0-3.5	3.0-3.5	3.0-3.5
FFO to debt (%) without income from last resort clients	23.0	27.9	24.5-25.5	24.5-25.5	24.5-25.5

Hera SpA--Key Metrics* (cont.)					
(Mil. €)	**2020a**	**2021a**	**2022e**	**2023f**	**2024f**
FFO to debt (%) with income from last resort clients	23.9	28.8	25.0-26	25.0-26	25.0-26

*All figures adjusted by S&P Global Ratings. §2021 year-end debt consists of financial debt of €3,227 million with key adjustments being €97 million in leases, €104 million in pensions, €138 million in asset-retirement obligations, and €447 million of put options on minority stakes. a--Actual. f--Forecast. FFO--Funds from operations.

We expect the significant investment plan will be financed by a moderate increase in debt over the planned period. As part of the business plan to 2025, Hera expects to invest €3.8 billion in 2021-2025, including cash acquisitions. Despite a positive free operating cash flow generation every year (around €2.5 billion in aggregate over 2022-2024), we believe Hera will post negative discretionary cash flow after dividends (€250 million cumulated in 2022-2024) and acquisitions (€250 million in aggregate in 2022-2024), which should entail approximately €750 million of additional debt in 2024 compared with 2021. Hera expects net financial debt (including the Ascopiave put option) to increase to €3.9 billion by 2024, compared with €3.26 billion at end-2021. Reported net leverage, however, will remain stable at slightly below 3x, thanks to EBITDA growth. This is reflected in our S&P Global Ratings-adjusted debt to EBITDA reaching a maximum of 3.3x over the period.

2021 results provide a strong starting point for our base-case projections. While part of the growth last year was due to the strong rebound from the COVID-19 pandemic, recovery was stronger than we had anticipated and was mainly driven by the waste and energy segments. The performance in the procyclical waste segment was also boosted by an increasing volume of industrial waste treated by Aliplast, Hera's regenerating plastic business. The energy segment benefited from the gas and power retail activities as well as by the energy efficiency services business, which profited from several government-funded initiatives to improve the energy efficiency of buildings (Bonus Facciate and Super Eco Bonus 110%). The regulated networks were relatively stable yoy, while the unregulated power segment experienced a slight decrease in EBITDA due to lower volumes on the safeguard market.

Company Description

Hera is one of Italy's largest domestic utilities, with headquarters in Bologna. It operates in four core businesses--gas, electricity, waste, and water--as well as providing other services.

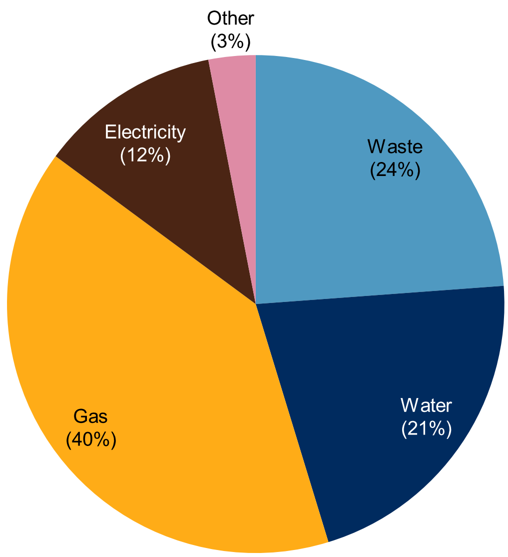
- Gas (40% of 2021 EBITDA): distribution (about 29% of gas EBITDA) and sales (about 53%), district heating and heat management (about 18%).
- Electricity (12% of 2021 EBITDA): distribution (about 34%), sales (about 37%), and co-generation (about 29%).
- Waste (24% of 2021 EBITDA): entire waste cycle, waste collection (about 24%), treatment, recovery, and disposal (about 76%).
- Water (21% of 2021 EBITDA): integrated water cycle, covers aqueducts, purification, and sewerage services, notably builds and operates the water infrastructure (sewerage systems and wastewater treatments plants).
- Other services (3% of 2021 EBITDA): public lighting, telecom, and some energy efficiency services.

The group has almost 9,000 employees and serves about 4.5 million customers in more than 350 municipalities in eight regions in northern and central Italy: Emilia-Romagna, Friuli-Venezia Giulia, Marche, Tuscany, and Veneto; as well as Sardinia.

On Dec. 31, 2021, Hera's shareholding structure included 111 of the municipalities it serves. Together with the other public shareholders, these municipalities hold approximately 46% of the share capital. There is a relatively low concentration of shares and a widespread private shareholding, which holds 54% (floating). The group reported an EBITDA of about €1.2 billion in 2021.

Chart 2

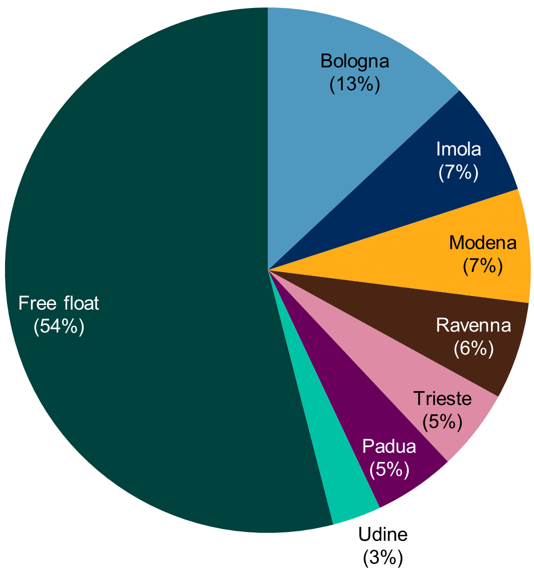
EBITDA Breakdown By Segment
2021



Source: S&P Global Ratings.

Chart 3

Shareholding Structure As At End-2021
Free float and various municipalities



Source: S&P Global Ratings.

Peer Comparison

Table 1

Hera SpA -- Peer Comparison

Industry Sector: Energy

	Hera SpA	IREN SpA	A2A SpA	Energie AG Oberoesterreich
Ratings as of May 17, 2022	BBB+/Stable/A-2	BBB-/Positive/--	BBB/Negative/A-2	A/Stable/--
	--Fiscal year ended Dec. 31, 2021--	--Fiscal year ended Dec. 31, 2020--	--Fiscal year ended Dec. 31, 2021--	--Fiscal year ended Sep. 30, 2021--
(Mil. €)				
Revenue	10,555.3	3,724.5	11,549.0	2,207.7
EBITDA	1,119.5	863.7	1,418.1	318.5
Funds from operations (FFO)	889.1	682.1	1,173.1	265.9
Interest expense	93.7	84.7	68.0	24.3
Cash interest paid	74.1	79.3	80.0	21.5
Cash flow from operations	1,061.3	732.9	1,398.0	378.5

Table 1

Hera SpA -- Peer Comparison (cont.)				
Capital expenditure	594.0	683.9	1,074.0	197.9
Free operating cash flow (FOCF)	467.3	49.0	324.0	180.6
Discretionary cash flow (DCF)	274.1	(125.6)	61.0	126.6
Cash and short-term investments	885.6	890.2	964.0	348.9
Debt	3,189.0	3,414.7	4,851.4	557.4
Equity	3,416.8	2,763.5	4,303.0	1,535.8
Adjusted ratios				
EBITDA margin (%)	10.6	23.2	12.3	14.4
Return on capital (%)	10.2	7.2	8.2	9.3
EBITDA interest coverage (x)	11.9	10.2	20.9	13.1
FFO cash interest coverage (x)	13.0	9.6	15.7	13.4
Debt/EBITDA (x)	2.8	4.0	3.4	1.8
FFO/debt (%)	27.9	20.0	24.2	47.7
Cash flow from operations/debt (%)	33.3	21.5	28.8	67.9
FOCF/debt (%)	14.7	1.4	6.7	32.4
DCF/debt (%)	8.6	(3.7)	1.3	22.7

Peers for Hera are selected based on the exposure to a common operating environment, such as Iren SpA and A2A, and on the portfolio of activities, such as the Austrian peer Energie AG Oberoesterreisch.

While smaller in terms of EBITDA, Iren is the closest peer for Hera by business mix. Both companies are multi-utilities with sole exposure to Italy and are fully regulated for around half of their EBITDA. Hera has a larger market share on waste treatment but has limited power generation capacity (only waste to energy with a total power capacity of roughly 300 megawatts), while Iren has a portfolio of mainly hydro (0.6 gigawatts [GW]) and thermal assets (2.6GW). A2A is Hera's closest peer by size and is also exposed to the same regulatory environment and market conditions as Hera and Iren, given it is another Italian multi-utility. A2A, however, has a weaker business risk profile assessment due to its lower share of regulated activities (around a third of its EBITDA in 2021, versus almost half for Hera and Iren). In fact, A2A has the largest generation portfolios among Italian multiutilities (7.7GW in 2021), mainly comprised of hydro (1.9GW) and combined-cycle gas turbine plants (5.2GW).

The Austrian peer Energie AG Oberoesterreisch is much smaller than Hera, by EBITDA, but is exposed to lower jurisdiction and operational risk, as measured by a lower country risk assessment. Energie AG also compares well with Hera on the business mix, having around 40% of EBITDA stemming from regulated network activities under a supportive regulatory framework.

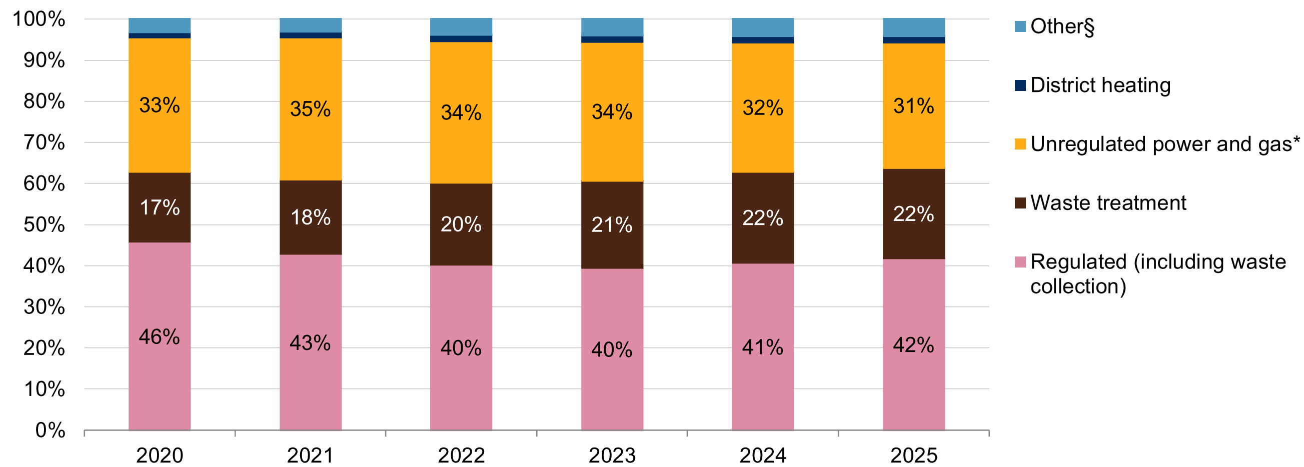
Business Risk: Strong

Hera's business risk profile continues to benefit from a large share of regulated activities and its diversified portfolio in one of Italy's wealthiest regions, where it holds a dominant market position. We view positively Hera's diversified portfolio of utility businesses in some of Italy's wealthiest regions, and its dominant local market position. Hera's business risk profile also benefits from the significant (about 43% of 2021 EBITDA, including urban waste collection) contribution from fully regulated water, gas, power distribution and urban waste collection and, starting from this year, treatment. All of these activities are remunerated under long-term concessions based on tariffs established by the national regulatory authority (ARERA). We expect fully regulated activities (including the regulated portion of regulated waste treatment) to continue to represent at least 40% of total EBITDA over 2022-2025 (see chart 4). This stems from sizable investments in networks, which will represent about 55% of total investments in the period 2022-2025, with waste collection and recycling representing close to 30%. The remainder will be invested in retail activities and ancillary services (such as public lighting and energy management and efficiency). About 18% of EBITDA comes from stable and partly regulated waste treatment activities focused in northern Italy. More volatile earnings come from energy, including retail power and gas supply activities, which account for 34% of 2021 EBITDA.

Chart 4

EBITDA Evolution By Type

% Regulated and unregulated, 2020-2025



Source: S&P Global Ratings. *Mainly retail activities. § Telecommunication, public lighting and other energy services.

Starting this year, both urban waste collection and treatment fall under the independent regulator ARERA's purview. From the second regulatory period (MTR-2), which began this year and will be in place until the end of 2025, the regulator has extended regulation from urban waste collection only to also include urban waste treatment. The aim is to increase service quality and to incentivize national investments in the sector, in a country with significant treatment plant scarcity and regional differences in service quality. The weighted-average cost of capital (WACC) on RAB has been set at 6.3% and 6.0% for collection and treatment, respectively. We can expect a decrease going forward, in line with the other regulated sectors. The remuneration parameters are the same as those in power, gas, and water, and all in all we believe the regulation is very similar to the one existing for water or gas. We understand Hera's RAB for waste treatment should be around €400 million, which adds to the €200 million of its already existing urban waste collection RAB. We view this development positively since it further improves cash flow stability and visibility for Hera's core waste operations.

The lower remuneration for regulated activities over 2022-2024 was in line with expectations and remained fully manageable for Hera thanks to its diversified business mix. In late December last year, the Italian regulator ARERA published the final determination paper on the new remuneration parameters for regulated activities for the period 2022-2024 (see "Updated WACC For Italian Regulated Electricity And Gas Networks Is In Line With Expectations Despite 60-70 Bps Cut," published on Jan. 7, 2022). The new WACC for power distribution has been set to 5.2% from 5.9% (70bps cut), to 5.6% from 6.3% for gas distribution and to 4.8% from 5.2% for water. The largest drivers of the remuneration revision were the lower risk-free rate and cost of debt, on account of the most recent macroeconomic scenario. For Hera, we estimate a €10 million lower remuneration every year for its regulated activities compared to the previous WACC period. That said, such reduction has been more than offset by higher profits in other divisions, such as waste and retail, given the positive price environment.

Despite administrative challenges in Italy, Hera is in a good position to win new gas distribution tenders or renew existing ones in all of its businesses, and its track record is positive. The bulk of Hera's activities depend on the successful implementation of tenders from regions, municipalities, and other public administration bodies. The most challenging operating environment relates to gas distribution tenders, for which the period between the start of the tender and the actual delivery of the concession to the new concessionaire is around 36 months. Hera has a good track record in renewing its expiring concessions and winning new ones. In 2021, it consolidated its position in the last resort services market, by winning one tender for safeguard and three for the protected electricity market, as well as six tenders for last-resort gas supply. In the water segment, the concession for the city of Rimini, which had expired in 2012, has been officially reassigned to Hera for another 18 years starting from 2021. The concession for Bologna's water area (ATO) expired in September 2021 and Hera is still charged with providing the service while waiting for the new tender process. Concessions for ATOs Ravenna and Forli Cesena, which were supposed to expire in 2023, have been extended until 2028, so the next expiring water concessions are Modena and Ferrara in 2024.

The upcoming retail market liberalization in Italy represents an opportunity for large players like Hera, but increased competition could squeeze margins further. Starting gradually from January 2023, with some auctions for small enterprises potentially taking place already this year, the Italian government has confirmed the end of the regulated regime for power and gas retail customers. We expect that around 11.8 million electricity retail points will be put to auction over the coming years. Gas customers will instead have the option to remain with their current supplier. The gas retail portfolio will in fact remain sticky, with most of Hera's retail additions coming from electricity clients, also driven by the country's electrification. While we expect Hera to add €15 million to its retail EBITDA in 2025 compared to last year, with its retail portfolio expanding to 4.5 million customers in 2025 from 3.5 million today, we also see increasing competitiveness in the market. Churn rates for power clients will go up to above 15% from around 13% in 2020-2021, and margins may squeeze further, but remain in the 7%-9% region. That said, because of Hera's size, brand reputation, and dominant position in Italy's north, we believe it is in a good position to reach its 2025 retail target. The last big acquisition of Ascopiave's gas and power clients has also increased Hera's capabilities in the liberalized gas and electricity retail market and proven its skills in integrating new customers and extracting cost synergies.

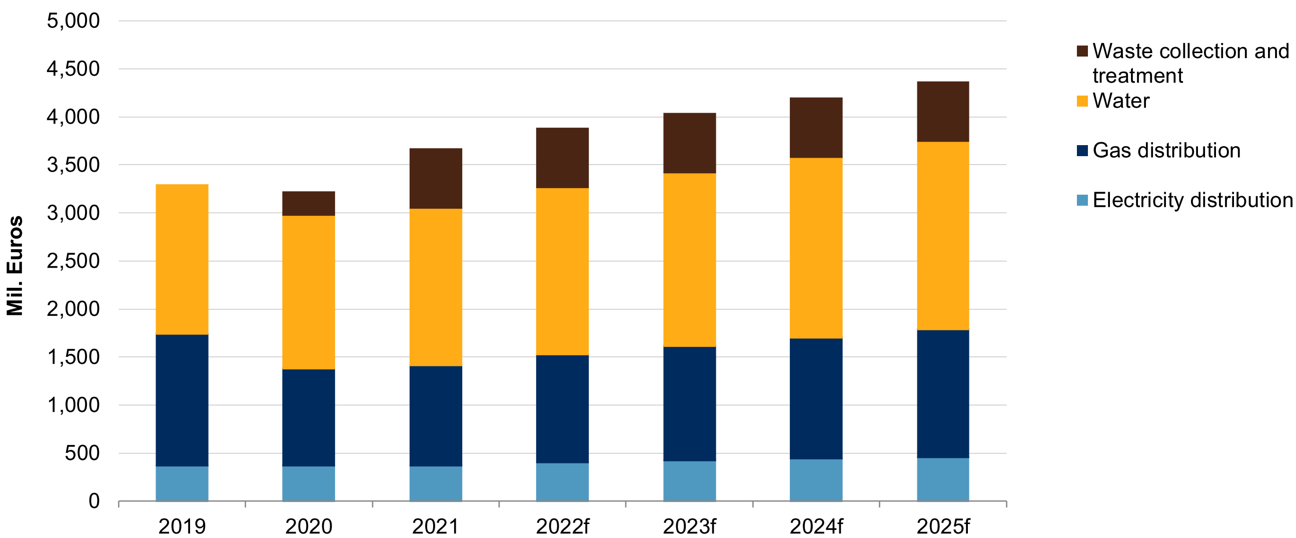
We expect acquisitions will contribute to Hera's growth, especially in the waste sector. The consolidation of small players is an integral part of Hera's strategy, especially in a highly fragmented market like the Italian one. While this has become more competitive over recent years, we expect Hera will continue to deliver on its targeted acquisitions as demonstrated by its solid track record. In the waste treatment segment for instance, Hera now holds a leading position thanks to the gradual acquisition of Aliplast, a company specialized in regenerating plastic waste. Going forward, we understand Hera might be interested in acquiring small waste players specialized in special waste treatment, as the company wants to affirm its position in other niche markets, such as carbon fiber regeneration.

Financial Risk: Intermediate

Hera's financial profile is supported by the group's stable cash flow generation, with about 45% of profits coming from fully regulated activities. Stable revenue from regulated businesses and growth in merchant activities will support Hera's adjusted EBITDA above €1.2 billion by 2024, in our opinion. Therefore, we expect adjusted FFO to debt (including income from last-resort clients) will consistently hover at about 26% over 2022-2024. Over the same period, Hera is maintaining a high level of capex, with €2.6 billion total investments including acquisitions, of which more than 50% will go into regulated networks. This should allow the total RAB (including district heating and waste) to increase to roughly €4.5 billion in 2025 from over €3 billion in 2021 (see chart 5).

Chart 5

RAB Evolution For Regulated Activities
2019a-2025f

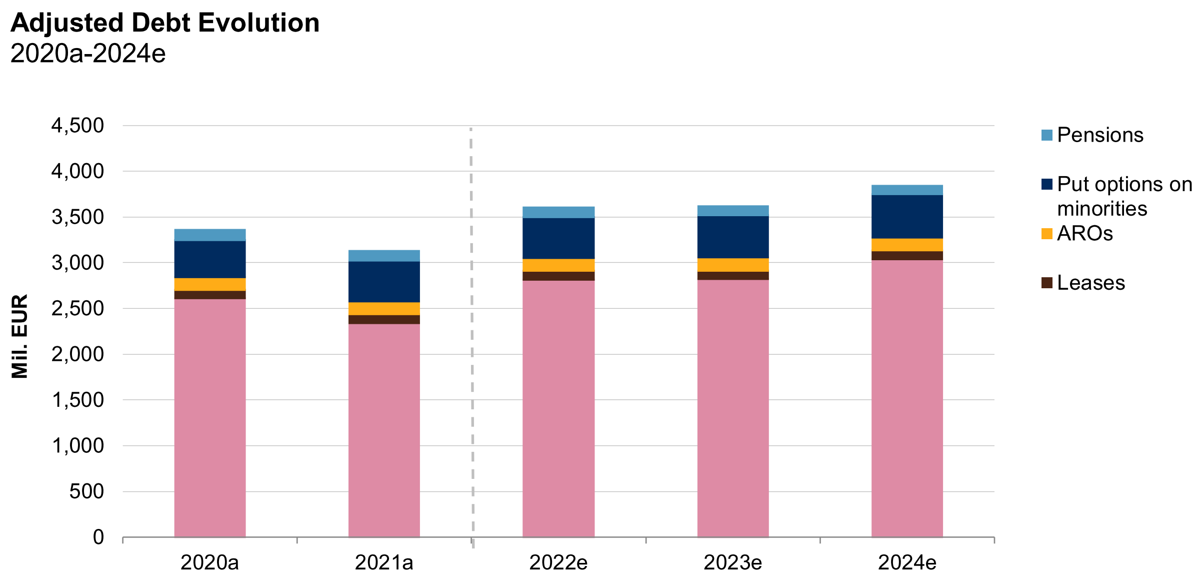


f--Forecast. Source: S&P Global Ratings. For waste, the regulator still has to define total RAB for urban waste treatment for Hera.

Hera's acquisitive strategy will not be detrimental to the rating as long as it continues to finance sizable transactions in credit-friendly ways. In the past, Hera's strategy was acquisitive, with the last large acquisition being that of Ascopiave's gas and power clients in 2019. For more details, please refer to "Hera's Planned Asset Swap With Ascopiave Does Not Derail Improvements In Credit Metrics For Now," published on July 31, 2019. Starting from 2019, we have consolidated the Ascopiave-related put option in Hera's adjusted debt, for about €419 million in 2021 (fair value of the equity portion only, excluding the dividends), which we expect to increase to around €465 million in 2025 (see chart 6). Starting from this year, we also include in our adjusted debt the put options stemming from more recent and smaller acquisitions in waste and energy (mainly Recycla and Eco Gas) for a total of around €27 million.

Although we do not include any large acquisitions in our base case up to 2024, we consider that there might be additional opportunities for Hera in the highly fragmented Italian power and gas sector as well as in the waste market. That said, we believe that such acquisitions will not pressure the rating as long as Hera continues to finance sizable transactions through share swaps, as it did with Ascopiave, or with additional credit remedy measures such as reducing other discretional investments or momentarily curbing dividends.

Chart 6



e--Estimate. AROs: asset-retirement obligations. *Mainly contingent considerations, trade receivables sold and power purchase agreements. Source: S&P Global Ratings.

Hera has exploited a good market window in 2021 to refinance part of its debt, which will lead to a leaner capital structure and a decreasing cost of debt. The multi-utility conducted an extensive liability management exercise in 2021, profiting from favorable market conditions before the deterioration in credit markets in the first half of 2022. Hera has been successful on repurchasing with a tender offer of the 2028 bond (€59.5 million outstanding) and on several other instruments maturing in 2024, 2026, 2027, and 2028 for a total of €300 million. The company also repurchased a private placement maturing in 2022 for €46 million. At the same time, Hera issued a new €500 million sustainability-linked bond which matures in 2034. These operations allowed the average cost of debt to decrease to 2.8% at end-2021 from 3% in 2020. The more efficient capital structure will also lead to cost of debt gradually decreasing toward 2.3% in 2025, which we include in our base case, even though we note floating-rate debt is set to increase to almost 30% of the total in 2025 from 12% today. Debt maturity is now above seven years.

Hera has a sound financial policy with a strong commitment to the current rating level. In our view, Hera's board of directors considers a balance between healthy growth and dividend payments and supports management's decisions, also thanks to the flexibility of Hera's public shareholders. We expect the dividend payout to remain at around 50%, which is controllable, in our opinion. Hera has a maximum leverage tolerance set at 3x net reported debt to EBITDA, which corresponds to roughly 3.5x on an S&P Global Ratings-adjusted basis. Furthermore, we believe that Hera's management would be ready to take remedial credit actions to preserve the rating, should the expansion embedded in the current plan be hampered by negative events, for instance by refraining from some of the discretional capex. We do not expect the recent change in Hera's top management to trigger any significant revision of the current strategy or financial policy, thanks to the company's stable governance practices and shareholders agreement in place with the public shareholders (patti parasociali).

Hera will benefit directly from the grants from the Italian Recovery Fund for only a small portion. The company has already presented €250 million worth of projects eligible to receive grants under the Italian post-pandemic Recovery Fund, most of which (around €100 million) related to the realization of new waste plants or to the modernization of existing ones. The business plan up to 2025 also includes over €70 million in capex for projects related to biomethane and hydrogen development that are awaiting for the relevant tenders to be published. If successful, these will represent an upside to the company's investment plan.

Financial summary

Table 2

Hera SpA--Financial Summary					
Industry sector: Energy					
	--Fiscal year ended Dec. 31--				
	2021	**2020**	**2019**	**2018**	**2017**
(Mil. €)					
Revenue	10,555.3	7,079.0	6,912.8	6,134.4	5,612.1
EBITDA	1,119.5	1,038.9	1,027.2	984.9	924.7
Funds from operations (FFO)	889.1	790.0	833.1	715.5	681.9
Interest expense	93.7	103.3	114.1	121.7	121.0
Cash interest paid	74.1	64.3	71.0	92.8	95.3
Cash flow from operations	1,061.3	929.6	737.6	624.5	778.8
Capital expenditure	594.0	511.7	538.5	469.7	445.8
Free operating cash flow (FOCF)	467.3	417.9	199.1	154.8	333.0
Discretionary cash flow (DCF)	274.1	199.8	35.4	(19.7)	192.1
Cash and short-term investments	885.6	987.2	364.0	535.5	450.5
Gross available cash	885.6	987.2	364.0	535.5	450.5
Debt	3,189.0	3,441.6	3,580.3	3,132.2	3,089.2
Equity	3,416.8	3,155.3	3,010.0	2,846.7	2,706.0
Adjusted ratios					
EBITDA margin (%)	10.6	14.7	14.9	16.1	16.5
Return on capital (%)	10.2	9.2	9.9	9.6	9.4
EBITDA interest coverage (x)	11.9	10.1	9.0	8.1	7.6
FFO cash interest coverage (x)	13.0	13.3	12.7	8.7	8.2
Debt/EBITDA (x)	2.8	3.3	3.5	3.2	3.3
FFO/debt (%)	27.9	23.0	23.3	22.8	22.1
Cash flow from operations/debt (%)	33.3	27.0	20.6	19.9	25.2
FOCF/debt (%)	14.7	12.1	5.6	4.9	10.8
DCF/debt (%)	8.6	5.8	1.0	(0.6)	6.2

Reconciliation

Table 3

Hera SpA--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. €)

	--Fiscal year ended Dec. 31, 2021--							
Hera SpA reported amounts								
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**S&P Global Ratings' adjusted EBITDA**	**Cash flow from operations**	**Capital expenditure**
Reported	3,226.8	3,200.2	1,096.4	626.5	76.3	1,119.5	1,045.4	588.7
S&P Global Ratings' adjustments								
Cash taxes paid	--	--	--	--	--	(156.3)	--	--
Cash interest paid	--	--	--	--	--	(96.2)	--	--
Cash interest paid: Other	--	--	--	--	--	22.6	--	--
Trade receivables securitizations	23.1	--	--	--	--	--	10.6	--
Reported lease liabilities	96.6	--	--	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	103.6	--	--	--	0.1	--	--	--
Accessible cash and liquid investments	(885.6)	--	--	--	--	--	--	--
Dividends received from equity investments	--	--	13.0	--	--	--	--	--
Power purchase agreements	14.5	--	5.8	0.5	0.5	(0.5)	5.3	5.3
Asset-retirement obligations	138.1	--	--	--	13.3	--	--	--
Nonoperating income (expense)	--	--	--	39.7	--	--	--	--
Noncontrolling interest/minority interest	--	216.6	--	--	--	--	--	--
Debt: Guarantees	0.2	--	--	--	--	--	--	--
Debt: Contingent considerations	25.2	--	--	--	--	--	--	--
Debt: Put options on minority stakes	446.6	--	--	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	8.0	8.0	--	--	--	--
EBITDA: Other income/(expense)	--	--	(3.7)	(3.7)	--	--	--	--
Depreciation and amortization: Other	--	--	--	3.7	--	--	--	--
Interest expense: Derivatives	--	--	--	--	3.5	--	--	--
Total adjustments	(37.8)	216.6	23.1	48.2	17.4	(230.4)	15.9	5.3
S&P Global Ratings' adjusted amounts								
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditure**
Adjusted	3,189.0	3,416.8	1,119.5	674.7	93.7	889.1	1,061.3	594.0

Liquidity: Strong

Hera's liquidity is strong. In our view, as of March 31, 2022, the company's planned available cash and committed credit lines cover cash outlays--mainly capex, debt service, and dividends--by more than 1.5x over the next 12 months and by more than 1x over the following 12 months. Furthermore, Hera has a high credit standing in the capital markets, strong relationships with banks, and solid and prudent risk management. We note that Hera has successfully contracted new committed credit lines with maturities in 2027 to replace those expiring next year.

Principal liquidity sources

- Our estimate of about €790 million of cash and liquid investments fully available for use;
- Available undrawn committed credit lines of €480 million maturing in 2027; and
- Our forecast of about €870 million of cash FFO over the next 12 months.

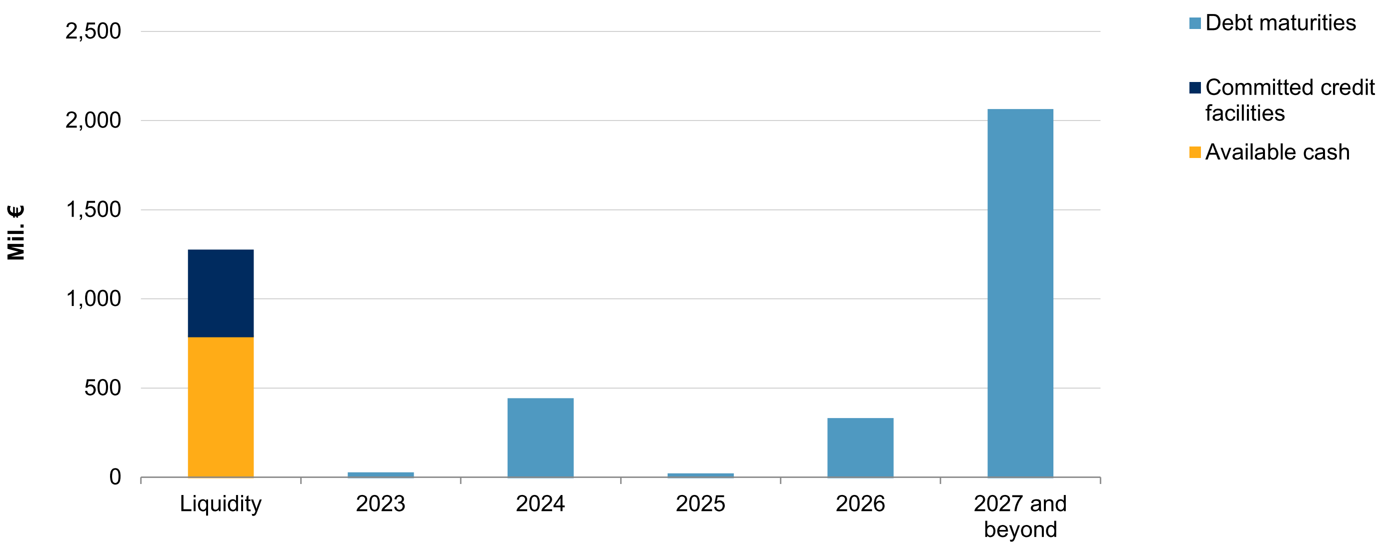
Principal liquidity uses

- Debt maturities of about €140 million over the next 12 months and about €80 million over the subsequent 12 months;
- Working capital outflows of around €190 million over the next 12 months;
- Capex of about €810 million over the next 12 months; and
- More than €230 million paid in dividends, including dividends to minorities.

Debt maturities

Chart 7

Liquidity And Bond Maturity Profile
At March 31, 2022



Source: S&P Global Ratings.

Environmental, Social, And Governance(ESG)

ESG Credit Indicators

E-1	**E-2**	E-3	E-4	E-5	S-1	**S-2**	S-3	S-4	S-5	G-1	**G-2**	G-3	G-4	G-5

ESG credit indicators provide additional disclosure and transparency at the entity level and reflect S&P Global Ratings' opinion of the influence that environmental, social, and governance factors have on our credit rating analysis. They are not a sustainability rating or an S&P Global Ratings ESG Evaluation. The extent of the influence of these factors is reflected on an alphanumerical 1-5 scale where 1 = positive, 2 = neutral, 3 = moderately negative, 4 = negative, and 5 = very negative. For more information, see our commentary "ESG Credit Indicators: Definition And Applications," published Oct. 13, 2021.

ESG factors have an overall neutral influence on our credit rating analysis of Hera SpA. Hera benefits from the circular economy megatrend and from about 50% of its EBITDA stemming from regulated networks (mostly water and gas distribution). Hera has no pure power generation activities and therefore a relatively low carbon intensity at 450 kilograms of CO2 per gigawatt-hour as of year-end 2021, mostly related to its waste-to-energy activities.

It stands out among peers as having an ambitious target of reducing scope 3 emissions by 37.6% by 2030 (compared with 2019).

In its water activities (about 21% of Hera's 2021 EBITDA), the company consistently fully meets regulatory requirements, notably leakage and water consumption reduction. Furthermore, it targets a 17% reduction in water intensity in 2024 versus 2019.

Given the extremely high power and gas prices, political scrutiny on gas and power retail is very high in Europe, in particular Italy. While we consider that affordability pressures could intensify and result in more negative regulatory measures for the company, hurting its retail activities and leading to extra working capital outflows, we believe that such potential negative impacts are well offset by Hera's diversified portfolio of activities.

Issue Ratings - Subordination Risk Analysis

Capital structure

At year-end 2021, Hera's capital structure comprised about €3 billion of gross debt, almost all of which was unsecured and issued at the parent company level (Hera SpA, the entity we rate).

Analytical conclusions

We rate Hera's senior unsecured debt 'BBB+', the same as the long-term issuer credit rating, since there are no significant elements of subordination risk in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating

BBB+/Stable/A-2

Business risk: Strong

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

Financial risk: Intermediate

- **Cash flow/leverage:** Intermediate

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 Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Related Research

- Italian Retail and Renewable Utility Plenitude Assigned Preliminary BBB Rating; Outlook Stable, April 28, 2022
- Italy 'BBB/A-2' Ratings Affirmed; Outlook Positive, April 22, 2022
- Europe's Exit From Russian Gas: 10 Questions On Utilities, March 17, 2022
- Italian Water Distribution Framework: Supportive, Feb. 22, 2022
- The Energy Transition And What It Means For European Power Prices And Producers: February 2022 Update, Feb. 10, 2022
- Italian Multi-Utility Iren SpA Rated BBB- On New Strategic Plan With Accelerated Investments; Outlook Positive, Dec. 9, 2021
- ESG Credit Indicator Report Card: Regulated Utility Networks, Nov. 18, 2021
- Hera Spa, June 30, 2021
- Italian Electricity And Gas Transmission And Distribution Frameworks: Supportive, Jan. 20, 2021

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-

Ratings Detail (As Of May 20, 2022)*

Hera SpA	
Issuer Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+
Issuer Credit Ratings History	
07-May-2021	BBB+/Stable/A-2
13-Mar-2018	BBB/Positive/A-2
12-Jul-2013	BBB/Stable/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.