Research Update:

Italian Multi-Utility Hera Affirmed At 'BBB+' On Expected Rebound In Credit Ratios This Year; Outlook Stable

May 25, 2023

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Rating Action Overview

- Italian multi-utility Hera SpA reported strong first-quarter 2023 results. The extraordinary negative impact on net debt and EBITDA related to the 2022 gas storage procurement has mostly fully reversed. This, and a somewhat normalized energy scenario, underpin our expectation that funds from operations (FFO) to debt will meet the 23% threshold for the rating this year, after dipping to 17.3% in 2022.
- Hera has also updated its strategic plan to 2026, with gross investments increasing to €4.1 billion and continuous EBITDA growth to well above €1.4 billion by the end of the plan compared with about €1.2 billion at end-2022, while its priorities and financial policy remain unchanged.
- We therefore affirmed our long-term 'BBB+' issuer credit and issue ratings on Hera and its senior unsecured debt.
- The stable outlook reflects our expectation that Hera will maintain S&P Global Ratings-adjusted FFO to debt above 23% in the next two years, and factors in management's commitment to the rating level and its prudent risk management and financial policy.

Rating Action Rationale

Despite significant but temporary working capital volatility, Hera's profitability stood the test of the energy crisis. Last year, Hera faced a material negative change in working capital mostly related to gas storage. It was preparing to face a potential shortage to service its relatively large gas retail customer base (more than 2 million customers) and to participate in the government's call for the country's energy security. Because of extremely high gas prices, especially during the summer, Hera's storage cash absorption peaked at €878 million in third-quarter 2022, at the start of winter, and finished the year at minus €504 million. That said, as of first-quarter 2023 this temporary effect had already reversed. Hera sold large portions of its gas-in-stock in the latter half of winter, therefore improving its net debt position. Its net reported debt to EBITDA decreased to 2.84x as of March 31, 2023, from 3.28x at end-2022 and 3.62x as of September last year. Reported EBITDA last year was €1,201 million, only slightly down from the €1,219 reported in the previous year. A €94 million temporary accounting effect, also stemming from gas storage, has also already been reabsorbed in the first quarter of 2023. These one-offs led to S&P Global Ratings-adjusted FFO to debt in 2022 declining materially, but temporarily, below our 23% threshold for the rating, at 17.3%. Excluding these one-offs, FFO to debt would have been close to 22%. That said, EBITDA performance remained resilient in our view, with a strong performance in the waste segment and a stable contribution from networks offsetting lower margins in power retail.

We expect credit metrics to already have bounced back in line with our threshold this year, which supports our stable outlook. Our base case assumes FFO to debt returning to above 23% already this year, mainly on an improvement in Hera's net debt driven by a positive change in working capital of €600 million-€700 million (about €400 million already realized in first-quarter 2023). We expect the next gas infilling season, which has already started, to weigh much less on the company's financials compared to last year. This reflects somewhat normalized gas prices, better supply prospects for Italy--which has now almost entirely replaced Russian gas--and lower demand from customers combined with high storage levels at the end of winter. Hera now expects to store roughly one-third of the gas volumes it had in stock last year, in line with historical pre-crisis levels. We forecast its adjusted EBITDA will hover above €1.3 billion this year, supported by normalization of margins in the retail segment and continuous growth in the networks and waste businesses. The recent finalization of a 60% stake in ACR, a leader in industrial waste treatment, will on its own boost EBITDA by €20 million.

The updated business plan involves no change to the company's strategic priorities, with most growth stemming from waste and networks. Hera plans to invest more than €4.1 billion over 2022-2026, which results in a further increase in average yearly capital expenditure (capex) to €824 million, up 59% from €768 million in the previous version of the plan. The figure includes about €370 million of M&A--the company has historically been an active acquirer of smaller operators--and more than €130 million of funds under the Italian Recovery Fund (PNRR). We understand the PNRR funds could reach up to €190 million and would be earmarked for projects related to the circular economy and decarbonization, including biomethane and hydrogen production. Capital allocation is skewed toward regulated networks (€2.2 billion or 54% of the total; mainly water and gas distribution grids) and waste treatment (€1.2 billion, 30%), which confirms these two business units as Hera's main axes of growth. We believe Hera is on track to achieve its EBITDA target of €1.47 billion in 2026, and could exceed this target.

Hera's short position in generation is offset by stable earnings from regulated activities and its strong position in waste treatment. Compared with other integrated Italian multi-utilities, Hera lacks vertical integration given that it only has a small waste-to-energy fleet and a large retail portfolio of more than 3.5 million customers (2.1 million gas and 1.4 million power retail clients), which helps explain why it suffered working capital volatility and squeezed margins especially in its power retail business amid the energy crisis last year. That said, we believe Hera will be able to pass through most cost increases to its customers as it has started repricing its contracts and has remodulated its commercial portfolio between fixed and variable price offers to recover margins. Its multi-utility business mix allows it to more easily diversify its exposure and offset downside risk compared with pure retailers or generators. A key rating strength is the stable contribution from regulated activities (including a small portion of district heating in the Bologna area, which we now consider to be regulated), which we expect will continue to contribute about 40% of the company's EBITDA and add to the stability and visibility of cash flows. Our strong business risk assessment is further supported by Hera's dominant position in waste treatment.

The rating on Hera remains capped at one notch above our rating on Italy. We note that Hera's profitability has proven resilient to economic developments 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. Its sole exposure to Italy remains a risk that we capture by limiting our long-term issuer credit rating to one notch above the sovereign (unsolicited, BBB/Stable/A-2). That said, we also view the Italian framework for regulated activities, which applies to around 40% of Hera's EBITDA, as providing a strong regulatory advantage and shielding the company from inflation, volume, and counterparty risk.

Outlook

The stable outlook reflects our expectation that Hera will maintain adjusted FFO to debt above 23% over 2023-2025. We also consider management's commitment to the 'BBB+' rating, and we understand it would be willing to adjust its financial policy should credit metrics deteriorate close to the rating thresholds without material prospects of recovery. Our stable outlook also factors in no further material deterioration of the macroeconomic and operating environment and no significant additional government intervention in the energy sector.

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 2026; or
- Significant unexpected changes in the regulatory framework and operating environment for Hera's businesses impede its ability to achieve EBITDA targets.

Rating downside could occur if Italy's economic environment turns more negative or if there are continued severe disruptions to energy markets, thereby constraining Hera's growth strategy. 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 Hera's stand-alone credit profile upward if it strengthens its credit metrics and achieves adjusted FFO to debt at or above 30% on a sustainable basis. An upgrade would also depend on our unsolicited rating on Italy.

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 (41% of 2022 statutory EBITDA): distribution (about 28% of gas EBITDA) and sales (49%), district heating and heat management (about 23%).
- Electricity (6% of 2022 EBITDA): mostly distribution and waste to energy, with a one-off negative contribution from retail.
- Waste (28% of 2022 EBITDA): urban waste collection (18%), treatment, recovery, and disposal (about 82%).
- Water (22% of 2022 EBITDA): integrated water cycle, covers aqueducts, and operates the water infrastructure (sewerage systems and wastewater treatments plants).
- Other services (3% of 2022 EBITDA): public lighting, telecom, and some energy efficiency services.

The group 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, 2022, 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 a statutory EBITDA of €1.2 billion in 2022.

Our Base-Case Scenario

Assumptions for 2023-2025

- Real GDP growth in Italy of 0.36%, 1.00%, and 1.39% in 2023, 2024, and 2025, respectively. However, GDP has a limited impact on Hera's revenue given the material share of EBITDA coming from regulated and contracted activities. Consumer price index growth of 6.5% in 2023, 2.25% in 2024, and 2.04% in 2025, with remuneration in the networks segment indexed annually to inflation.
- Remuneration of Hera's regulated activities driven by weighted-average cost of capital (WACC) at 4.8% for water services, 5.6% for gas, 5.2% for electricity distribution, 5.6% and 6.0% for waste collection and disposal, respectively. We assume up to 80 bps increase in WACC next year for water, gas, and power.
- Adjusted EBITDA margin recovering to pre-crisis levels of about 10%.
- Cash taxes of €120 million per year on average.
- Positive swing in working capital of around €650 million-€700 million this year as the gas storage effect fully reverses and the energy scenario normalizes.
- Annual capex of around €820 million on average, up from about €710 million in 2022.
- Cash acquisitions of around €200 million in aggregate over the period.
- A stable average cash dividend distribution of €240 million annually.
- Adjusted debt stabilizing at €4.1 billion in 2025 after its €4.5 billion peak in 2022.
- Average cost of debt increasing to above 3.0% from 2.6% at end-2022.

- Put options on minority stakes (mainly Ascopiave) at about €460 million. The put option on Ascopiave expires in 2026 and we expect Hera to exercise it at that time.
- No material impact from the recent flooding in the Emilia-Romagna region, where Hera has already suspended energy and waste bills in the most affected areas.

Key metrics

Hera SpA--Key Metrics*

(Mil. €)	2021a	2022a	2023e	2024f	2025f
EBITDA	1,119	1,054	1,300-1,350	1,300-1,350	1,300-1,350
Capital expenditure	594	715	800-850	800-850	800-850
Debt§	3,189	4,457	4,000-4,100	3,900-4,000	4,100-4,200
Dividends	193	220	230-240	230-240	240-250
Debt to EBITDA (x)	2.8	4.2	3.0-3.5	3.0-3.5	3.0-3.5
FFO to debt (%)	27.9	17.3	24-26	23-24	23-24

*All figures S&P Global Ratings-adjusted. FFO--Funds from operations. e--Estimate. f--Forecast

Liquidity

Hera's liquidity is strong. In our view, as of March 31, 2023, its 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. In April, Hera contracted a new committed €450 million RCF with maturity in 2028, which adds to its comfortable liquidity buffer.

Principal liquidity sources are:

- Our estimate of more than €2 billion of cash and liquid investments fully available for use;
- Available undrawn committed credit lines (excluding the new RCF) of €580 million as of March 31, 2023, most of which maturing in 2027;
- Positive working capital inflows; and
- Our forecast of about €980 million of cash FFO over the next 12 months.

Principal liquidity uses are:

- Debt maturities of about €150 million over the next 12 months and €500 million over the subsequent 12 months;
- Capex of about €810 million over the next 12 months; and
- More than €230 million paid in dividends, including dividends to minorities.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors have an overall neutral influence on our credit rating analysis of Hera SpA, though the company continues to benefit from the circular economy megatrend, which is a cornerstone of its strategic plan. Hera has very limited power generation activities, mostly waste-to-energy, and therefore a relatively low carbon intensity. Furthermore, it targets a 37% reduction in scope 3 emissions by 2030 compared to 2019. In its regulated activities, the company consistently fully meets regulatory requirements, notably leakage and water consumption reduction.

Even though energy prices have somewhat normalized compared to last year, we consider that affordability pressures remain a concern for its retail clients, which will continue to keep political and regulatory scrutiny on the sector.

Governance is a neutral consideration in our analysis. We note the smooth transition in Hera's top management over the past year.

Issue Ratings - Subordination Risk Analysis

Capital structure

At year-end 2022, Hera's capital structure comprised about €5.6 billion of gross debt (both bonds and loans), 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 because 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 (medial volatility table)

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: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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 | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, 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 Multi-Utility Iren SpA Upgraded To BBB On Successful Plan Execution; Outlook Stable, April 27, 2023
- Italy 'BBB/A-2' Ratings Affirmed; Outlook Stable, April 21, 2023
- EMEA Utilities Outlook 2023: France, Italy, And Spain: Credit Quality To Withstand Fiscal And

Regulatory Intervention, Jan. 19, 2023

- Western Europe Regulated Gas Utilities Handbook 2022, Nov. 4, 2022
- Hera SpA, May 20, 2022
- Italian Water Distribution Framework: Supportive, Feb. 22, 2022
- European Water Regulatory Frameworks, Feb. 17, 2022

Ratings List

Ratings Affirmed	
Hera SpA	
Issuer Credit Rating	BBB+/Stable/A-2
Senior Unsecured	BBB+