Research Update:

Italian Multi-Utility Hera SpA Upgraded To 'BBB+' On Improved Credit Metrics; Outlook Stable

May 7, 2021

Rating Action Overview

- Hera SpA has demonstrated resilient operating performance amid a challenging environment related to the COVID-19 pandemic, with 2020 reported EBITDA up 3.5% year-on-year to €1,123 million.
- We anticipate adjusted funds from operations (FFO) to debt will hover at about 24% in 2021-2023, spurred by an about 4% EBITDA increase on average per year, which should more than offset additional spending on Hera's strategic plan.
- Hera will continue to benefit from predictable cash flows from the high share of fully regulated activities in its 2021-2024 business plan, which will represent about 45% of the earnings mix.
- We therefore raised our long-term issuer credit and issue ratings on Hera SpA and its senior unsecured debt to 'BBB+' from 'BBB'.
- The stable outlook indicates that we believe Hera SpA will retain credit metrics commensurate with the 'BBB+' rating in the next two years, with FFO to debt averaging 24%, factoring management's strong commitment to this rating level.

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Rating Action Rationale

Hera reported 2020 results that were above our expectations, demonstrating resilience amid ongoing COVID-19 uncertainty. These stronger-than-expected results notably stemmed from the robust performance of Hera's network activities and ancillary services, which more than offset declining waste prices due to relatively low hedging amid declining prices and volumes. Reported net debt for 2020 stood at €3,250 million, declining from €3,280 million in 2019, with better-than-expected working capital management throughout the pandemic. This signals the resilient nature of Hera's business, supported by regulated activities, limited exposure to power prices at its waste-to-energy plants, and no direct exposure to generation capacity. Thanks to the strong 2020 results, adjusted FFO to debt including income from clients neared 24%, only marginally lower than the 24.3% registered in 2019. Income from last-resort clients has an about 80 basis points (bps)-100 bps effect on adjusted FFO to debt, depending on its magnitude year from year. This income is derived from interest on delayed payments from public administration authorities in Italy.

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. Hera's business risk profile benefits from the significant (about 46% of 2020 EBITDA) contribution from fully regulated water, gas, power distribution and, since 2020, urban waste collection activities under long-term concessions that are remunerated based on national regulatory authority (ARERA) tariffs. Since last year, urban waste collection activities (6% of 2020 EBITDA) are also regulated in Italy with a framework like that for gas distribution, which further improves cash flow stability and visibility for Hera's core waste operations. We expect fully regulated activities to remain about 50% of total EBITDA at the end of Hera's 2021-2024 business plan. This stems from sizable investments in networks, which will represent about 65% of total investments, with waste collection and recycling representing more than 20%. The remainder will be invested in retail activities and ancillary services (such as public lighting and energy management). About 17% of EBITDA comes from stable waste treatment activities focused in northern Italy. More volatile earnings come from energy, including retail power and gas supply activities, which account for 33% of 2020 EBITDA. Other services, including public lighting and telecommunication, account for 3%.

Organic growth and strong cash flow will lead to improved credit metrics over 2021-2023 despite capital expenditure (capex) acceleration. Under its strategic plan to 2024, Hera plans to invest on aggregate €3.2 billion, 40% 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 business, which will add about €100 million thanks to the €84 million contribution from the Ascopiave acquisition. This, combined with stable revenue from regulated businesses and growth in merchant activities, will support Hera's adjusted EBITDA growth above €1.2 billion by 2023. Therefore, we expect adjusted FFO to debt (including income from last-resort clients) will consistently hover at about 24% over 2021-2023. The total regulatory asset base (RAB; excluding district heating) should expand at a compound annual growth rate of 2.8% to €3.8 billion in 2024 from €3 billion in 2020. As a result of the higher investments, reported net debt should increase about €400 million by 2024. Nevertheless, we project that adjusted leverage will remain under control at 3.4x-3.5x, thanks to stronger EBITDA growth and healthy operating cash flow.

Hera's prudent financial policy underpins credit metrics improvement and will allow the company to control leverage. In the past, Hera's strategy was acquisitive, with the last large acquisition that of Ascopiave's gas and power clients in 2019. Although we do not include any large acquisition in our base case up to 2023, we do not exclude that there might be additional opportunities for Hera in the highly fragmented Italian power and gas sector. That said, we believe that such acquisitions will not be detrimental to the rating so long as Hera continues to finance sizable transactions through share swaps, like for Ascopiave, or with additional credit remedy measures. In addition to increased capex, we include in our forecasts a stable cash dividend of €210 million on average over 2021-2023, working capital outflows related to concessions and tenders, and delayed payments from clients. Even after considering all of this, Hera will still be able to generate positive free operating cash flow (FOCF) of €100 million-€150 million per year over 2021-2023.

Outlook

The stable outlook reflects our expectation that Hera will maintain adjusted FFO to debt (including income from last-resort clients) at or above 24% over 2021-2023. We also take into account management's commitment to the 'BBB+' rating, with our understanding the company is willing to adjust financial policy should credit metrics deteriorate close to the rating thresholds. Our stable outlook also factors in Hera's timely execution of the strategic plan.

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 would view as a prudent financial policy;
- Hera does not successfully implement its strategic plan until 2024; or
- Changes in the regulatory framework for Hera's network business (water, gas, and electricity) impede its ability to achieve EBITDA targets.

The rating could face pressure if the economic environment in Italy turns more negative, thereby constraining Hera's growth strategy and EBITDA. We would also revise the outlook to negative if we take a similar action on Italy (unsolicited; BBB/Stable/A-2), because we cap our rating on Hera at one notch above the sovereign rating.

Upside scenario

Although unlikely at this stage, we could revise our stand-alone credit profile for Hera upward 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 would also depend on our unsolicited rating on Italy. Given Hera's sensitivity to the Italian economy, we allow the long-term rating to be only one notch higher than our long-term sovereign rating.

Company Description

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

- Gas (33% of 20 EBITDA): distribution (about 37% of Gas EBITDA) and sales (about 53%), district heating and heat management (about 10%).
- Electricity (17% of 2020 EBITDA): distribution (about 24%), sales (about 50%), and co-generation (about 26%).
- Waste (23% of 2020 EBITDA): entire waste cycle, waste collection (about 26%), treatment, recovery, and disposal (about 74%).
- Water (24% of 2020 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 (5%): public lighting, telecom, and minor services

The group has over 8,900 employees and serves about 4.4 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.

At Dec. 31, 2020, 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 €1.123 billion in 2020.

Our Base-Case Scenario

Assumptions

In our base case for 2021-2023, 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.
- Revenue increases by 3% per year on average.
- Reported EBITDA increases by about 3.4% on average,reaching above €1.1 billion by 2023.
- A stable EBITDA margin hovering at about 15%.
- Income from last-resort clients of about €32 million annually.
- Current taxes of €115 million-€125 million.
- Negative changes in working capital by €50 million on average.
- Annual capex of €600 million on average, up from about €500 million in 2019 and 2020.
- A stable cash dividend distribution of €190 million-€230 million, in line with the payout ratio recently revised upward.
- Net reported debt of €2.9 billion-€3.2 billion.

Key metrics

Hera SpA Key Metrics*

Mil. €	2019a	2020a	2021f	2022f	2023f
EBITDA	1,027.20	1,038.90	1,082.90	1,120.90	1,170.40
Capital expenditure	538.5	511.7	615-625	615-625	580-600
Debt§	3,580.30	3,441.60	3650-3700	3750-3950	4000-4200
Dividends	161.5	163.3	190-195	200-210	220-230
Debt to EBITDA (x)	3.5	3.3	3.3-3.5	3.4-3.6	3.4-3.6

Hera SpA Key Metrics* (cont.)

Mil. €	2019a	2020a	2021f	2022f	2023f
FFO to debt (%)	23.3	23	24-24.5	24-24.5	23.5-24

*All figures adjusted by S&P Global Ratings. The credit metrics represented for 2021-2023 include income from last-resort clients. §2019 year-end debt consists of financial debt of €3,599 million with key adjustments being €94 million in leases, €114 million in pensions, €137 million in asset-retirement obligations, and €402 million of put options on minority stakes. a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations.

Liquidity

Hera's liquidity is strong. In our view, as of Dec. 31, 2020, the company's planned available cash and committed credit lines cover cash outlays--mainly capex, debt service, and dividends--by 1.74x over the next 12 months and by 1.77x 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.

Principal liquidity sources as of Dec. 31, 2020, include:

- Our estimate of about €987 million of cash and liquid investments fully available for use;
- Available undrawn committed credit lines of €600 million maturing beyond 12 months, which reduce to about €500 million over the following 12 months; and
- Our forecast of about €730 million of cash FFO over the next 12 months.

Principal liquidity uses as of the same date, include:

- Debt maturities of about €501 million over the next 12 months and about €116 million over the subsequent 12 months;
- Working capital outflows of €25 million over the next 12 months;
- Capex of about €615 million over the next 12 months; and
- More than €194 million paid in dividends, including minorities.

Issue Ratings - Subordination Risk Analysis

Capital structure

At year-end 2020, Hera's capital structure comprised about €3 billion of gross debt, almost all of which was unsecured.

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 (Medial volatility table)

Anchor: bbb+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (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
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 20, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013

- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, 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 A2A SpA Affirmed At ‘BBB/A-2’ On Announced Strategic Plan Through 2030; Outlook Stable, Feb 8, 2021
- The Energy Transition And What It Means For European Power Prices And Producers: January 2021 Update, Jan. 27, 2021.
- Italian Electricity And Gas Transmission And Distribution Frameworks: Supportive, Jan. 20, 2021
- Italian Multi-Utility Hera's EBITDA Growth Should Offset Debt Increase In Ambitious New Strategic Plan To 2024, Jan. 14, 2021
- Hera SpA, June 26, 2020
- The Energy Transition And What It Means For European Power Prices And Producers: Midyear 2020 Update, June 8, 2020.
- A2A SpA, June 1, 2020

Ratings List

Upgraded; Outlook Action; Ratings Affirmed

	To	From
Hera SpA		
Issuer Credit Rating	BBB+/Stable/A-2	BBB/Positive/A-2
Senior Unsecured	BBB+	BBB