

Company Name: Hera
 Company Ticker: HER IM
 Date: 2018-11-08
 Event Description: Q3 2018 Earnings Call

Market Cap: 4,006.86
 Current PX: 2.69
 YTD Change(\$): -.22
 YTD Change(%): -7.560

Bloomberg Estimates - EPS
 Current Quarter: N.A.
 Current Year: 0.179
 Bloomberg Estimates - Sales
 Current Quarter: N.A.
 Current Year: 5681.429

Q3 2018 Earnings Call

Company Participants

- Tomaso Tommasi di Vignano
- Stefano Venier
- Luca Moroni

Other Participants

- Javier Suarez
- Roberto Letizia

MANAGEMENT DISCUSSION SECTION

Operator

Good morning. This is the Chorus Call operator. Welcome to the Presentation of the Financial Results as at 30th September 2018 of Hera Group. All participants are in listen-only mode. Following the initial presentation, there will be a Q&A session. [Operator Instructions]

And I'd like to give the floor to Mr. Tomaso Tommasi di Vignano, Executive Chairman of Hera Group. You have the floor.

Tomaso Tommasi di Vignano

Thank you and good afternoon, everybody. We are here with the usual team to discuss the first nine months of results for 2018. The results show a good continuity vis-à-vis the first half of the year. And with the third quarter, we are able to confirm results, which are in line, if not slightly ahead, compared to the forecast included in the business plan.

Our revenues are up by 7.2%, also thanks to the trends of prices in net tariffs and the energy volumes, which have all contributed significantly to the results. As far as EBITDA is concerned, it is up by 3.3%, also thanks to the efficiency actions which continued and also thanks to the expansion of our market share in the energy sector.

And keep in mind that the energy customer expansion is equal to further 97,000 customers, to which we can also add the effects of an operation. The transaction, which happened at the beginning of the current quarter and which following the final signing of the contracts, it will bring about a further 30,000 customers, which means that we will be well above the 100,000 new customer threshold, which is in line with our external growth, our external expansion, which is something that we have always focused on.

As far as EBIT is concerned, it is up by 5.2% despite a significant increase in the accruals and depreciation. Our pre-tax results are up by 9.7%, in line with the constant improvement, which has characterized all of the recent quarters and in line with the attention and the focus we placed on improving our financial management.

And finally, as far as the net profit is concerned, the growth is equal to 14.1% and it certainly benefits from the tax rate and as we'll be seeing in details of this significant improvement, which has been happening in recent quarters and it contributes to the bottom line results. I apologize the microphone was switched off for a minute.

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Moving on to page 2. Now, the first figure I'd like to focus on is the growth in EPS. And with a 16% growth, it is now up to [ph] €0.142 (00:04:32) over the nine-month period. And the ROE also had a good performance and it is now above 10.2%. And this result is also comforting when it comes to the choices made, both in terms of capital allocation and in terms of the already mentioned organic growth, along with our ability to be efficient in our cost reduction policies.

Page 3 gives you a breakdown of the EBITDA growth. The total growth is equal to €23.9 million and we had a balanced breakdown between the regulated businesses and the liberalized ones, both of which contributed with some €20 million. Although we had to take into account that the liberalized part of the business also has to subtract the non-positive effects as far as power generation is concerned due to the downtime in a couple of our plants in the first months of the first half of the year.

As far as the liberalized businesses are concerned, I'd like also like to mention the increase in sales and trading volumes in both gas and electricity, the expansion of our energy customers I mentioned earlier, and a good trend as far as prices are concerned, especially waste for the treatment of waste, which further confirmed a trend which was already present in the second quarter this year.

The net contribution of the liberalized area of businesses and minus the downtime for our plants, which are worth some €17 million, gives us a final result equal to €3.2 million.

I'd now like to give the floor to Stefano for the business-by-business breakdown of these figures.

Stefano Venier

Good afternoon, everyone. As usual, I will be beginning with the waste sector. And in Q3, we are seeing the effects of the dynamics that we already commented for the first half of the year. In fact, our performance is guided by the price trends.

For the liberalized treatment of waste, of the €9.8 million, which represent the overall organic growth, I think it's safe to say that roughly €7 million are, in fact, linked to the growth in prices year-on-year despite slightly lower volumes. I think this is the element which characterizes Q3 this year, which contributed to the €2 million of the overall €9.8 million growth.

Besides this, we also had a good contribution from our waste collection activities. Those results were up by €1 million, plus the effects on the electricity market, which were already very good last year and which were also confirmed this year with some slight improvements. A slightly negative impact was brought about by the revenues on the tariffs to treat and dispose of the non-sorted urban waste collection. Given the current prices, those volumes contracted slightly compared to last year.

Another thing which we can take note of for the third quarter, in fact it refers to September 30 and I'm referring to the biomethane plant which started it up in Sant'Agata, you may have read up in the newspapers. We had mentioned the fact that it would have started up in the early October and we delivered.

We inaugurated the plant in early October. We began the production of biomethane besides the compost treatment activities, which had already begun at the beginning of June. It is a very innovative plant, as you know, and for the time being, everything is good on this front. And at the end of the year, we will have another stage in the strengthening of our asset base, which is an essential part of our approach to the circular economy when it comes to the treatment of sorted material and I'm referring to the very first significant investment in our Aliplast Company in the [indiscernible] (00:10:28) site where in the upcoming weeks and within the end of the year, we will be inaugurating a new line for the cleaning of PET, allowing us to increase the volumes of recycled PET, an investment which was worth some €8 million.

There are no special or substantial elements which characterize Q3. There's a great continuity compared to the results posted in the initial part of the year.

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Moving on to the next page and moving on to the network sector, you have to bear with me because I will be going through the various elements on a business-by-business level, which contributed to this improvement, which is close to €20 million year-on-year, which you can see on the right-hand side of the graph, €186 million in the water sector with a plus €8 million result.

Part of this contribution came from the tariff updates following the investments made in the sector, which is worth €3 million or €4 million. The remaining €4 million were brought about by increasing efficiency in our operations, along with an improvement in commercial management quality.

As far as gas distribution is concerned, at the end of September, we posted €98.2 million in terms of industrial margin. In this case, €3 million are connected to revenues from tariffs, along the lines of the same motivations I mentioned for water. Slightly less than €3 million are linked to White Certificates, which is something we manage with a great deal of attention since they are so important for our activities, and the remaining part stems from efficiency on the business.

Finally, we also have electricity distribution, which also improves by 8.5% equal to €2.5 million. EBITDA in this case, €1 million is linked to a change in revenues and the remaining portion links to other activities included in the business.

Finally, district heating, the improvement percentage here is significant, although we know the percentages can be misleading. Of course, it depends on the base you refer to in absolute terms, so the increase is worth €1 million. And that is essentially driven by the increased volumes in that specific business.

It's worth taking note of the fact that a component which is typically important in the development of this regulated business, and I'm referring to the revenues linked to the accessories such as new meters or the moving of meters [ph] on force of the – (00:13:39) in the first nine months of the year, we have a continuation of a weak situation, which means we're standing around the same levels we had last year, which were among the lowest of the past 10 years, which shows that the real estate and industrial sectors are still a little slow in Italy.

All in all, the result of this activity is satisfactory, we feel, given the fact that we have reached the €326 million, generally speaking, for the first months of the year.

Moving on to the third area of business, which, as the Chairman was mentioning earlier, was a little slowed down by the asset management activities. Therefore, if we consider this distinction, we'll note that the supply and trading part of the business had a positive result worth €11.8 million, most of which due to gas activities which benefited from greater volumes and some margins which were better compared to the previous year especially in trading. Whereas, the electricity part of the business had a marginal contribution to the results. Although we know that last year, we posted some very good results.

Generally speaking, as you can see on the right-hand side of the graph, we are now well above the 2.45 million customer mark and by rounding up those figures, we would reach 2.5 million customers and I'm sure that is something we will be achieving by the end of the year. We'll be at the 2.5 million mark, of which 1.4 million refer to the gas customers. The remaining 1 million customers are electricity customers.

In terms of customer base, in terms of the supply services, we have to mention an event which took place in September, the effects of which will – have started to be felt in early October. And I'm referring to the new FUI and default market in the gas sector. As in the past, we made a bid in the tender, which is managed by the national Authority.

The outcome of the tender allowed us to broaden the customers we manage, which for the upcoming 12 months will cover roughly 50% of the Italian territory, I'm referring to the last instance, service for domestic customers. Whereas in the default market for enterprises and the public administration, we now have nine areas, allowing us to increase the users that we serve by a further 40,000 with a contribution to marginality which will be around €5 million at the end of this year and €5 million in early 2019 in general terms.

And just to give you a breakdown of the margins, out of the €216 million, which represents the supply margin to September 2018, roughly €108 million refer to gas supply and trading, and the remaining €95 million refer to electricity supply and trading. And the final portion refers to power generation services, which, as I mentioned, suffered compared to the first nine months last year given the fact that the plant we have a stake in, the Teverola plant, was stopped for a

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few months due to maintenance issues, whereas the Sparanise plant had a one unit on maintenance for a longer period due to an accident.

Besides this, of course, another element which impact is the reform on the [ph] in balances market (00:18:21) which went through a radical transformation, as you know, in October 2017.

Moving on to the lines below EBIT and EBITDA, we have had a further contraction in financial management, which is now €65.5 million over the first nine months of 2018. Besides our managing of the debt [indiscernible] (00:19:07) which contributed to this was the proceeds from the credit management, especially for the last instance markets.

From the point of view of profitability and EPS, the Chairman already briefed you and therefore, let me just update the tax rate performance and consistently with the end of H1, in the end of last year. As through September 30 this year, besides the amendments made by the previous government on the IRES tax, we have also felt the benefits linked to the incentivization of the hyper-amortization, extra-amortization and ultra-amortization, you can choose that name that you prefer, and I'm referring to the incentives for research and development in Industry 4.0 and sales promotion.

I'll now give the floor to Mr. Moroni for a few comments on the cash flow.

Luca Moroni

Good afternoon, everyone. We concluded the first nine months in 2018 with a net financial position equals to €2.64 billion, in line with last year's figures, with a debt-to-EBITDA ratio which is equal to 2.6 times. The operating cash flow and production prior to the distribution of our dividends and other operations, which is equal to €62 million, which stem from an operational lever of €534 million, which is already commented, of course, in the business-by-business breakdown.

We had an absorption of our net working capital equals to €153 million, which stems from three aspects. The first is the volumes and prices, especially for those customers stemming from the [ph] last instance market (00:21:11), and more specifically from the [indiscernible] (00:21:14) market, plus the cash provisions, which, as usual this year, we have an absorption on the working capital given by the [indiscernible] (00:21:34) and finally the alignment process on debts to suppliers, which is at around 60 days on average.

As far as investments are concerned, we invested €284 million in terms of CapEx invested during the nine-month period. As we already saw during the H1 presentation, we distributed a dividend equal to €150 million, which means that our debt is in fact stable compared to the previous year and it is affected by the seasonality of the end of September that we'll be seeing the natural development vis-à-vis the last few months of the year.

I believe we have given you a very straightforward presentation concerning our performance, which is very much in line with our programs. In fact, we have achieved 42% of our EBITDA growth target compared to 35% of the business plan time horizon. Therefore, for this point of view, this is further confirmation of the fact that we are moving ahead very well. And as we mentioned earlier, our target as far as the end of the year is concerned is to be above the €1 billion EBITDA threshold, which was our target. And given today's figures, I think we are confident we'll be able to achieve that threshold.

Our growth has continued. The financial and tax management has continued very well.

And at this point, I'll open the floor to any questions you may have.

Q&A

Operator

This is the Chorus Call operator. We will now begin our Q&A session. [Operator Instructions] The first question is from the Italian conference call by Javier Suarez, Mediobanca.

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<Q - Javier Suarez>: Good afternoon, everyone. I have three questions for you. The first refers to the waste business, slide number 4. You explained that the organic growth you mentioned, which is equal to €10 million or €9.8 million specifically, is due to prices.

What is your feeling for 2019 is concerned? How sustainable is this price trend? What kind of visibility do you have for 2019? That would be very interesting. And can you also explain the minus €3.7 million, what is that due to?

And moving on to slide number 6, second question on the supply activities, I'd like to hear what your view is on the evolution of supply margins in the gas and electricity. And from your point of view, what can the evolution of the margin be in 2019?

And the third question is on the infrastructure business. I'd like to have a focus on water business and the water distribution business. We read recently that there was a hearing at the Environment Committee in Parliament, can you give us a view on the discussion concerning the new legislation on water? Any possible statement, any further clarification on the topic that would be much appreciated. Thank you.

<A>: As far as the waste prices are concerned, honestly speaking, we aren't rethinking our approach. We are in line with growth. We have also had some contacts with other players, which attended the Rimini Fair, which is the most important waste fair in Italy. And just a few days ago – this week, in fact – as far as waste treatment prices are concerned, we are not expecting any surprises.

And despite statements made by a few political entities, the prices also are also brought about by the shortcomings of lack of waste treatment assets especially in certain parts of the country. In fact, it cannot even be defined as a crisis anymore. They're real disaster in terms of the number of assets available.

Along with that, we also have the possibilities to go along a new path with new approaches for players that, of course, require new investments and new initiatives. So, of course, the waste treatment sector has to step its game up and there are no clues as to a possible slowdown in prices, not from the market side at least.

As far as supply is concerned, you were asking us how we see future margins. Well, it's easier to answer for gas than electricity. As far as gas is concerned, all of the raw material procurement activities have now been concluded. We have signed the new contract for the 2018-2019 thermal year are now concluded. And compared to the previous year, margins have been holding.

There may have been some minor fine tunings, which are fairly natural in a scenario with growing prices, such as the one we had ever since May or June this year. But again, nothing major. Nothing worth mentioning, I think.

In the electricity sector, as you know, as far as our industrial customers are concerned, we have launched our commercial campaign in the recent weeks for part of the market. And compared to last year, in these first nine months, we have been seeing a slight reduction in margins. Again, the motivations are the same ones I mentioned earlier.

And there's a reasonable level of continuity with a few effects stemming from competition which exist, of course. And given a market context in which – whenever industrial customers have to pay a higher price for a commodity, they obviously have some further difficulties to deal with. But looking forward, I don't expect any major changes in the market.

As far as yesterday's audition is concerned, the audition we attended yesterday as a company, although the audition lasted over the past two days, the Enterprises Association mentioned then the – and individual companies also stated, as you read in the press today, we feel there is a certain distance between ourselves and the solutions in the bill.

There is a distance on three or four main points. The water industry and [indiscernible] (00:31:25) industry is very complex over the past three or four years. It has been able to bridge the infrastructure gap, especially in sewage systems and purification systems, which dated too many years ago. And this industry has a program – its investments into long term. It cannot look at things in the short term.

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And this is a fundamental element that we wanted to underline and this is something that all companies mentioned. And by all companies, I mentioned that not only that the Committee listened to the largest listed companies; they also received the publicly owned companies, the companies which are owned by public-private partnership and they are also attended by the in-house companies. And all companies said how important it is to have players which have a sizable entity because we have major challenges to face.

As far as the past is concerned, I mentioned the challenges we have to face. And as far as the future is concerned, we have to face the effects of climate change, which are even more challenging and they require skills, competencies and size, and any solutions which envisages a fragmentation of players on a provincial level would be going back to 30 years ago, in fact, and it wouldn't allow this country to be able to deal with the problems it has.

The second aspect that all stakeholders, all players agreed on was how important the Authority's role was in terms of revitalizing the water system, both in terms of investments and in terms of the mechanisms required to increase the quality for citizens.

And a direct consequence of this debate, all of the main players – and I'm referring to statistics we have concerning the larger players and I'm not just referring to the listed players, but also the large in-house companies such as [indiscernible] (00:33:51) and others – again, all of the players have reached a level of investment per inhabitant, which is equal to at least €40 with a total invested amount which, in general, is above depreciation, which means that implicitly, all of these players are reinvesting a major amount, if not all of their profits, into the business itself. And they're doing so to strengthen and improve the quality of the system.

This is another aspect that all companies agree on. And as a way of concluding my comments on these recent events, I have to say that the people who were present at the meeting, people who were present when I took the floor certainly understood the topics we were trying to explain.

Thank you very much.

Operator

[Operator Instructions] The next question is by Roberto Letizia, Equita SIM.

<Q - Roberto Letizia>: Good afternoon and thank you. I'd like to have some further information on the new contracts you mentioned when describing the energy sector, the FUI and the default contracts. If I understood correctly, these two contracts will bring about an EBITDA contribution worth €10 million, but I may have misunderstood. Is that so? Did I understand it correctly? And is this on top of the business plan figures or if they replace any other item included in the business plan? Can you please clarify this item for me?

<A>: Let me make a distinction as far as the short term is concerned vis-à-vis the business plan. In the short term, we were already managing certain territories with the FUI and default services. These services, these tenders we had bid in would have expired September 30 and therefore, we made a new bid in the new tender.

The profitability of these activities up to September 30 on a yearly basis, but keep in mind that I'm referring to a thermal year, therefore these margins are always distributed between Q4 and Q1 of the following year. That was worth €5 million.

The new tender allowed us to broaden the perimeter of our services, meaning that this broader perimeter will bring about a margin, which is worth €10 million to €11 million. €5 million of which will refer to Q4 2018 and €5 million will refer to Q1 2019.

After that, in September 2019, presumably there will be a new tender. I'm saying presumably through the simple fact that there will be a new tender without any amendments to the regulation. The new tender will, of course, have a 12-month duration.

<Q>: How does this compare to the budget or to the business plan?

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<A>: Well, compared to the budget, the plus €5 million in the Q4 are on top. As compared to the business plan is concerned, we – our hypothesis was that in this [ph] last instance market (00:38:04) plus the [ph] Sant'Agata (00:38:05) market, the center for which will be happening in November, our forecast was that in the years beginning in 2019, we may have had an overall profitability worth some €50 million.

Obviously, the FUI/default tender allowed us to start giving some real figures to that hypothesis, something that we hope to improve, thanks to the tender which will be happening within the end of November.

<Q - Roberto Letizia>: Thank you very much. That was very clear.

Operator

Mr. Tomaso di Vignano, there are no further questions for the time being.

Tomaso Tommasi di Vignano

Well, then, thank you very much for your attention. And we will talk to you soon, probably for the presentation of our new business plan. Thank you.

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