Research Update:

Italian Multiutility Hera Affirmed At 'BBB' On Robust Performance Expected In Challenging Conditions; Outlook Positive

June 10, 2020

Rating Action Overview

- We expect Hera's operating performance will remain resilient to Italy's challenging operating conditions, reporting 2020 EBITDA slightly below the €1.085 billion in 2019, although a possible increase in bad debt remains a major risk.
- From 2021, we anticipate Hera's organic growth will resume, notably in the retail, networks, and waste divisions, thanks to the large investment plan.
- We are affirming our 'BBB' long-term rating on Hera.
- The outlook is positive because we could upgrade Hera in the next six to 12 months if Hera's cash flow remains resilient to the challenging operating and macroeconomic conditions, especially if our forecast of adjusted funds from operations (FFO) to debt comfortably above 23% holds in 2021-2022, after the expected dip below 23% in 2020.

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Rating Action Rationale

We expect Hera to withstand the challenging Italian operating conditions caused by the lockdown measures and the consequent negative economic effect. Hera generates about 50% of its EBITDA through fully regulated activities and has limited exposure to declining power prices of the waste-to-energy plants, with no direct exposure to generation capacity. In particular, we expect the following effects on Hera's 2020 numbers, causing 2020 reported EBITDA to remain slightly below the €1.085 billion reported in 2019:

- EBITDA impact of maximum 5%, notably stemming from lower gas and electricity volumes sold in 2020, with an expected decline of 10%. We expect a decline of similar magnitude also for waste volumes, which will affect the waste treatment business (about 20% of 2020 EBITDA).
- Working capital outflow of at most €150 million, arising from expected delays in supply division customer' payments of gas and electricity bills.

Organic growth will continue to drive credit metrics' improvement from 2021 and thereafter.

We expect operating conditions to return to normal in Italy in 2021. After the annual drop of about 8% expected for 2020, 2021 power and gas volumes sold should also normalize. Hera will continue its operating growth focusing on the retail, networks, and waste divisions. We expect reported EBITDA to increase well above €1.2 billion in 2022, while at the same time reported debt will increase to €3.3 billion in 2022 versus €3.1 billion in 2019. But EBITDA growth will more than compensate the expected increase in debt stemming from investments, with capital expenditure (capex) expected to average €540 million over 2020-2022, compared with €533 million in 2019. As a result, we expect adjusted FFO to debt (including income from last-resort clients) to remain above 23% over 2021-2022, compared with 24.3% in 2019. However, we note that COVID-19 will drive down expected earnings for 2020 and adjusted FFO to debt (including income from last-resort clients) is expected to fall below 23% in 2020.

The asset swap with Ascopiave SpA will have an only marginally negative effect on Hera's business risk position, with the group losing about 4% of its fully regulated EBITDA from gas distribution.

On July 30, 2019, Hera announced its binding offer for Ascopiave's gas and power clients (EBITDA of about €60 million-€80 million) in exchange for 188,000 gas-distribution delivery points in northeast Italy. This asset swap will not result in any cash outflow, but leaves Hera with a put option on the remaining shares in EstEnergy SpA (52% owned by Hera), which can be exercised wholly or in part each year over seven years. Starting from 2019, we have consolidated the Ascopiave-related put option in Hera's adjusted debt, for an amount of about €400 million in 2019, which we expect to increase to more than €440 million in 2022. Adjusted debt to EBITDA is expected to remain almost flat compared with the 3.4x of 2019 (with an increase in 2020 driven by the expected working capital outflow of at most €150 million).

Hera's business mix is supported by about 50% of profits coming from fully regulated activities.

We positively view Hera's diversified portfolio of utility businesses in one of Italy's wealthiest regions, and its dominant local market position. Hera's business risk profile benefits from the significant (about 43% of 2019 EBITDA) contribution from fully regulated water, gas, and power distribution activities under long-term concessions that are remunerated based on tariffs established by the national regulatory authority (ARERA). As of Jan. 1, 2020, the waste collection business (about 7% of 2019 EBITDA) is also regulated in Italy, based on efficient costs and identified quality parameters, while tariff regulation for treatment plants is planned from 2021.

We expect fully regulated activities (including waste collection) to continue to represent about 50% of total EBITDA at the end of Hera's 2019-2023 business plan. This is because the company will dedicate €2.2 billion out of the €2.9 billion budgeted capex to fully regulated activities. About 18% 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 28% of EBITDA, and other services, including public lighting and telecommunication, which account for 4%.

Outlook

The outlook is positive because we could upgrade Hera in the next six to 12 months if its profitability continues to remain resilient to challenging operating and macroeconomic conditions. In particular, we expect the lockdown measures in Italy to hit Hera's EBITDA by a maximum of 5%, translating into adjusted FFO to debt (including income from last-resort clients) remaining well above the threshold for an upgrade over 2021-2022, after a dip below 23% expected in 2020 caused by the pandemic-related business slowdown.

In our base case, we do not assume sizable debt-funded acquisitions, which could lead us to reassess the company's creditworthiness.

Upside scenario

We could raise the rating in the next six to 12 months if Hera maintains its sound financial performance while deploying its investment plan, despite the difficult operating conditions in Italy, by generating healthy cash flow after capex and dividends. This should translate into EBITDA remaining stable at about €1.1 billion in 2020 and rising from 2021, while FFO to debt (including income from last-resort clients) remains above 23% for a prolonged period.

An upgrade would also depend on Hera maintaining a prudent financial policy and our unsolicited rating on Italy remaining at 'BBB'.

Downside scenario

We could revise the outlook to stable over the next six to 12 months if Hera's FFO to debt (including income from last-resort clients) remains below 23% over 2021-2022, after the expected dip in 2020. This could happen if:

- Hera undertook larger cash acquisitions or increased its dividend, deviating from what we would view as a prudent financial policy;
- The economic environment in Italy turned more negative, thereby constraining Hera's growth strategy and hitting the company's EBITDA by more than 5%; or
- Changes in the regulatory framework for Hera's network business (water, gas, and electricity) were to impede the company's ability to achieve its EBITDA targets.

We would also revise our outlook to stable if we lower our unsolicited rating on Italy to 'BBB-' from the current 'BBB', because we cap our rating on Hera at one notch above the 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, environment--as well as providing other services.

Gas (31% of 2019 EBITDA): distribution (about 45% of Gas EBITDA) and sales (about 45%), district heating and heat management (about 10%).

Electricity (16% of 2019 EBITDA): distribution (about 35%), sales (about 50%), and co-generation (about 15%).

Waste (24% of 2019 EBITDA): entire waste cycle, waste collection (about 30%), treatment, recovery, and disposal (about 70%).

Water (24% of 2019 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 lightning, telecommunications and minor services

The group has over 8,670 employees, and serves around 4.4 million customers in more than 350 municipalities in 8 regions in northern and central Italy: Emilia-Romagna, Friuli-Venezia Giulia, Marche, Tuscany, and Veneto; as well as Sardinia.

As of Dec. 31, 2019, Hera's shareholding structure included 111 of the municipalities it serves. Together with the other public shareholders, these municipalities hold a total of approximately 46.6% of the share capital. There is a relatively low concentration of shares and a widespread private shareholding, which holds 53.4% (floating). The group reported an EBITDA of €1.085 billion in 2019.

Our Base-Case Scenario

Assumptions

In our base case for 2020-2022, we assume:

- Real GDP growth in Italy of -9.9% in 2020, 6.4% in 2021, and 3.2% in 2022.
- GDP growth has only limited impact on Hera because a large share of its revenue is derived from long-term contracted or regulated activities. Thus, we expect limited impact from COVID-19, with revenue and EBITDA slightly declining in 2020.
- Furthermore, we expect revenue to increase at 9% in 2021 and 3% in 2022.
- A stable reported EBITDA margin of about 16%.
- Cash taxes of €120 million-€130 million over 2020-2022.
- Negative changes in working capital by €70 million on average, with a peak expected in 2020.
- Average annual capex of about €550 million over 2020-2022.
- A stable cash dividend distribution of €160 million-€180 million per year, based on a 55%-60% payout ratio. Any changes in the dividend policy would weigh on the rating.
- Net reported debt of €3.1 billion-€3.3 billion.

Hera SpA Key Metrics*

	--Fiscal year ended Dec. 31--				
(Mil. €)	**2018a**	**2019a**	**2020e**	**2021f**	**2022f**
EBITDA	1,010	1,066	1,030-1,070	1,100-1,150	1,100-1,150
FFO	741	872	820-850	880-910	910-950
Debt§	3,132	3,580	3,750-3,800	3,750-3,800	3,900-4,000
Dividends	151	162	160-170	160-170	175-185
Capex	470	539	530-560	530-560	520-550
FFO to debt (%)	23.6	24.3	22.0-23.0	23.0-24.0	23.0-24.0
Debt to EBITDA (x)	3.1	3.4	3.4-3.7	3.3-3.6	3.3-3.6

*All figures adjusted by S&P Global Ratings. The credit metrics represented include income from last-resort clients. §2019 year-end debt consists of net financial debt of €2.693 billion, with key adjustments being €96 million in leases, €125 million in pensions, and €397 million for the Ascopiave deal-related put option. a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. Capex--Capital expenditure.

Liquidity

Hera's liquidity is strong. In our view, as of March 31, 2020, the company's planned available cash and committed credit lines cover cash outlays--mainly capex, debt service, and dividends--by about 1.7x over the next 12 months and by about 1.4x over the following 12 months. Furthermore, Hera has a high credit standing in the capital markets, strong relationships with banks, and solid, prudent risk management.

Principal liquidity sources as of March 31, 2020, include:

- Our estimate of about €500 million of cash and liquid investments fully available for use;
- Available undrawn committed credit lines of €550 million maturing beyond 12 months, which reduce to about €500 million over the following 12 months; and
- Our forecast of more than €780 million of cash FFO over the next 12 months.

Principal liquidity uses as of the same date, include:

- Debt maturities of about €215 million over the next 12 months and about €357 million over the subsequent 12 months;
- Working capital outflow of €125 million over the next 12 months;
- Capex of about €545 million over the next 12 months; and
- More than €165 million paid in dividends, including dividends to minorities.

Issue Ratings - Subordination Risk Analysis

Capital structure

At year-end 2019, 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 issuer credit rating, since there are no significant elements of subordination risk in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Positive/A-2

Business risk: Strong

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

Financial risk: Significant

- Cash flow/Leverage: Significant (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

- Sovereign rating: (unsolicited) BBB/Negative/A-2

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 | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Hera SpA; Aug. 23, 2019
- Hera's Planned Asset Swap With Ascopiave Does Not Derail Improvements In Credit Metrics For Now; July 31, 2019

Ratings List

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