MOODY'S
INVESTORS SERVICE

Credit Opinion: Hera S.p.A.

Global Credit Research - 18 Dec 2014

Bologna, Italy

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating -Dom Curr	Baa1
Senior Unsecured	Baa1

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Key Indicators

Hera S.p.A.

	2013	2012	2011	2010
(FFO + Interest Expense) / Interest Expense	4.4x	4.4x	4.2x	4.3x
FFO / Net Debt	15.5%	15.4%	15.6%	14.8%
RCF / Net Debt	11.2%	10.9%	10.6%	10.4%
FCF / Net Debt	2.0%	-6.1%	-3.1%	-3.8%

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

- Diversified business mix and sizeable presence in regulated activities mitigate exposure to weak macroeconomic conditions

- New investment plan anticipates further deleverage, but execution risk increases from 2016

- Consolidation strategy remains credit friendly, but acquisition risks have risen

Corporate Profile

Hera S.p.A. (Hera) is one of the largest multi-utilities in Italy. Almost 57.5% of Hera's shares are currently held by over 200 municipalities (public shareholders), the largest of which is the City of Bologna, which owns approximately 10% of the company. Hera has a strong territorial presence in Emilia Romagna region and, increasingly, in the North-East of Italy, following its mergers with AcegasAps (January 2013) and AMGA (July 2014). The company has a widely diversified and vertically integrated portfolio of public utility services, which includes regulated water and energy networks, waste collection, treatment and energy from waste generation activities, gas and electricity retail sales, and ancillary activities such as district heating and public lighting. In 2013, Hera reported consolidated revenues of EUR4,851 million and an EBITDA of EUR831 million.

SUMMARY RATING RATIONALE

Hera's Baa1 rating reflects the company's moderate operating risk profile and diversified business mix, which provides good earnings predictability and low cash flow volatility given the sizeable contribution of regulated activities to the company's profits (regulated networks and other regulated business contribute to approximately half of the group's EBITDA).

Our rating also factors in the deleverage trajectory implied in Hera's 2014-18 industrial plan, i.e., fund from operations (FFO)/net debt trending to the upper teens, a level that we regard as commensurate for the rating given Hera's risk profile. However, we see a material execution risk on Hera's plan. Together with metrics still weakly positioned for a Baa1 rating, this execution risk is the key reason for our negative outlook. That risk comes from a still weak domestic economy and a persisting decline in energy demand, as well as a likely reduction in regulatory returns starting from 2016, although we believe that the company has the flexibility to execute balance-sheet strengthening measures not included in the current investment plan, if needed, to preserve its credit profile.

Hera's rating also accounts for the company's credit-friendly external growth model, aimed at small-target acquisitions through stock-for-stock, synergy-generating mergers. We expect that Hera will maintain the same growth strategy in the future, although the operating and financial profile of Hera's targeted transaction may become less favourable and put negative pressure on the rating in case of material departure from its historically credit-friendly strategy.

Finally, our rating incorporates Hera's strong liquidity, with limited refinancing needs for the next 2-3 years.

DETAILED RATING CONSIDERATIONS

DIVERSIFIED BUSINESS MIX AND SIZEABLE PRESENCE IN REGULATED ACTIVITIES MITIGATE EXPOSURE TO WEAK MACROECONOMIC CONDITIONS

Hera's diversified business mix and overall limited exposure to specific risk hotspots mitigates the effects of a still weak domestic business environment.

Approximately 44% of Hera's EBITDA is attributable to regulated energy and water networks, which are supported by stable and predictable regulatory frameworks drawn by the same independent body, Italy's Regulatory Authority (AEEGSI), under similar cost recovery and capital remuneration schemes, bearing no or little volume risk.

Water services account for 24% of the company's consolidated EBITDA (2013). The new regulatory framework for water services is a key credit supportive feature for the company. The new regulation approved in 2013 by AEEGSI has confirmed the provisional framework approved in 2012. Water networks tariffs follow a RAB-based, cost recovery mechanism analogous to the established framework that AEEG applies to regulate Italy's electricity and gas T&D networks. Regulated activities comprise the full chain of water and wastewater operations, including connections, wholesale and retail supply and sewage/wastewater treatment services. Although the regulation is still pretty recent and partially untested, its implementation risk is decreasing, as 2014 and 2015 tariffs for Hera's districts and the related investment plans have already been approved by the Authority.

Electricity and gas distribution networks account for approximately 20% of Hera's consolidated EBITDA. Gas distribution networks started their new 6-year tariff cycle in 2014. Existing regulatory mechanisms were confirmed, with a limited reduction of the applicable base WACC, to 6.9% from 7.7%, and a tightening of the allowed cost base. Hera operates its gas networks through concession agreements granted by local authorities, which are expired or will expire by 2018. Starting from 2015, and for the following 3-4 years, all the existing Italian gas distribution concessions will be re-tendered, as part of a reform aimed at reducing the number of operators and fostering efficiency. Hera could lose some of its existing concessions in the process. However, when a concession is awarded to a new operator, the latter has to pay the residual value of the assets under concession to the exiting concessionaire. Hera intends to participate in tenders where it is already the incumbent operator. The company has earmarked approximately EUR240 million for the completion of its existing gas network perimeter.

Hera has low exposure to wholesale electricity prices and to weak conditions for thermoelectric producers as a result of its minor presence in electricity generation. The majority of Hera's generation capacity is in fact attributable to its waste-to-energy and biogas/biomass plants (154MW installed capacity, 1Twh electricity production), whose profitability is principally driven by waste incineration and green incentives on electricity production.

The company has instead a more significant presence in natural gas retail sales and gas trading activities, which together accounted for 14% of its EBITDA in 2013 (2.2 bcm sold to retail, industrial and commercial customers).

Starting from Q4 2013, AEEGSI's reformed retail tariff has linked the raw material component of regulated retail prices to gas spot prices, rather than oil prices as had been the case previously. As a result, Hera's gas sales and trading margins came under pressure as the company has seen a reduction in the extra profits it had previously been able to lock in owing to its short gas procurement strategy. However, the effect is mitigated by Hera's limited exposure to regulated retail customers, who account for just 40% of its total gas sales.

As for Hera's environment division (30% of consolidated EBITDA), a fragmented and under-dimensioned waste treatment market increases the potential for Hera to reach its special waste volume target of 3.5 million tonnes (from 1.94 million tonnes in 2013), raising its market share in the north-eastern regions and capturing part of the infra-regional waste flows from southern and central Italy. While we see a significant execution risk for Hera's special waste commercial strategy in addition to macroeconomic risks on volumes and prices, we believe they are mitigated by (1) Hera's strong (and regulated) urban waste collection base; (2) its increasing number of treatment contracts with industrial and municipal counterparties; (3) a limited need for further investment in its existing asset base; and (4) evidence of capacity constraints for the Italian waste treatment market. Moreover, Hera's Waste-to-Energy plants (WTE) fleet contributes to a further reduction in the volatility of the division's results, given its very high load factors and mostly incentivised electricity and thermal production.

NEW INVESTMENT PLAN ANTICIPATES FURTHER DELEVERAGE, BUT EXECUTION RISK INCREASES FROM 2016

Hera's new investment plan, disclosed in October 2014, targets a progressive reduction in net debt/EBITDA (as reported by the company) to 2.8x (2018), from 3.1x (2013).

The new plan envisages EUR2.1 billion capex between 2014-18. Hera's network division capex accounts for EUR1.34 billion, its environment division for EUR0.53 billion.

In its new plan, Hera expects to increase its EUR810 million consolidated EBITDA of 2013 to EUR1,020 million by 2018. Hera's networks are the main contributor to the targeted growth, accounting for EUR130 million of the targeted EBITDA increase. The environment division contributes for EUR80 million, while the EBITDA of the energy division remains flat in Hera's plan.

The new plan reiterates the key role of small acquisitions to support Hera's growth, as M&A activities and synergies extracted from acquired companies represent almost 60% of the targeted increase in EBITDA. After the recent merger with the local utility AMGA Udine, the company is targeting two further acquisitions between 2015-18. The local utility Aimag is the most likely short-term acquisition target. We expect that Hera will execute the transaction through a share swap.

The company's new investment plan confirms the previous EUR0.09/share dividend floor up to 2018. Overall, the new plan would result in an approximately EUR300 million increase in net debt by 2018 (from EUR2.6 billion, as reported by company in 2013, after IFRIC11 adjustments).

If successfully executed, Hera's new plan would support its current rating positioning and the company's overall creditworthiness. However, we caution that a worsening of the domestic environment, which would particularly affect the most cycle-exposed activities in Hera's portfolio (i.e., downstream energy markets and waste treatment), might hinder the company's ability to fully achieve its targets. Also, we anticipate pressure on regulated cashflows from 2016, as a result of likely lower regulated returns, reflecting a reduction in interest rates. In these scenarios, we would expect Hera to execute balance-sheet strengthening measures not included in the current investment plan to preserve its credit profile.

We expect the company to exhibit a funds from operations (FFO)/net debt ratio of 16%-17% and a retained cash flow (RCF)/net debt ratio of around 12%-13% in 2014 and 2015, confirming the improvement on its historical levels. In order to support the current Baa1 rating over the medium term, Hera would need to exhibit FFO/net debt positioned at least in the upper teens in percentage terms, and RCF/net debt in the low teens.

CONSOLIDATION STRATEGY REMAINS CREDIT FRIENDLY, BUT ACQUISITION RISKS HAVE RISEN

The high degree of voting rights fragmentation resulting from Hera's ownership by more than 200 local municipalities has historically prevented any major shareholder interference in the company's corporate strategy, favouring the execution of a balanced financial policy over the years, based on growth through small share-swap acquisitions, contained leverage and reasonable dividends.

Hera's external growth strategy historically resulted in the extraction of significant synergies from the acquired entities (EUR10-15 million per year, on average, since 2002). The acquisition of Acegas (at the end of 2012) generated approximately EUR8 million of cost synergies in 2013. The acquisition of AMGA (July 2014) added up to EUR5 million of further targeted synergies, to a company's target of EUR36 million cumulated synergies to be achieved by 2018. Both the acquisitions were executed through share swap agreements.

At the end of November 2014, Hera submitted a binding offer for the portfolio of 800,000 gas and electricity supply customers that the German utility E.ON intends to sell. E.ON portfolio was not included in Hera's 2014-18 investment plan. The offer is yet to be accepted by E.ON, and its details are undisclosed at present. However, we understand that the offer is likely to be financed with Hera's existing cash and/or with additional debt. If executed, the transaction would also increase Hera's exposure towards energy downstream activities, adding up to Hera's existing two million customers' portfolio. Although we believe that the increase in operating and financial risk would not be dramatic, E.ON's portfolio acquisition might signal a more aggressive stance on external growth and a shift towards a less credit-friendly financial policy.

Liquidity Profile

As of September 2014 Hera exhibits a strong liquidity profile, backed by EUR702 million of cash and cash equivalents and EUR450 million of committed credit lines (completely undrawn). Most of these facilities will remain available for withdrawal at least until the end of December 2015, with the longest maturity pertaining to a EUR100 million EIB credit facility expiring at the end of 2017. All the committed lines benefit from the absence of any financial covenant and material adverse change (MAC) clause.

At the end of the third quarter of 2014, Hera's reported gross debt amounted to some EUR3.6 billion, the bulk of which (about 75%) will expire beyond 2018, for an average debt duration of 6.5 years. In the next 12 months, some EUR500 million are due for repayment, including the maturity of a EUR180 million EIB loan. Hera's schedule of debt repayments does not exhibit any other relevant short-term cash outflow until the first quarter of 2016, when approximately EUR200 million bonds will expire.

Overall, our current rating recognises Hera's strong liquidity position, underpinned by a limited refinancing risk, and the company's efforts to maintain good cash availability, to meet its debt maturities and to execute its investment programme.

Rating Outlook

The negative outlook on Hera's rating reflects Hera's exposure to a weak domestic macroeconomic environment, the risk of a decrease in regulated returns starting from 2016 and the additional pressures that it could exert on the company's financial and business risk profiles. The outlook also reflects Hera's weak, albeit improving, credit metrics relative to its current Baa1 rating and the risk that they could deteriorate to a level no longer consistent with the company's current rating positioning.

What Could Change the Rating - Up

Given the negative outlook, we do not expect upward rating pressure in the short term. A precondition to stabilising the current negative outlook on the company's rating would be financial metrics within the guidance discussed above, i.e., FFO/net debt in the upper teens and RCF/net debt in the low teens.

What Could Change the Rating - Down

We would consider downgrading Hera's rating if (1) the company were unable to continue to improve its credit metrics in line with our guidance of FFO/net debt positioned at least in the upper teens in percentage terms, and RCF/net debt in the low teens; (2) Hera's external growth strategy resulted in a significant deterioration of its credit profile, either in terms of business mix or resulting leverage; (3) unfavourable regulatory determinations or political interferences materially affected Hera's regulated businesses; (4) the company's cyclical operations were significantly affected by a further deterioration of the Italian macroeconomic environment; (5) the company's liquidity profile deteriorated materially, for instance as a result of unfavourable net working capital dynamics.

Other Considerations

There is no single rating methodology for Hera given the group's diversified portfolio of businesses. The business risk profile reflects the characteristics of the relatively stable regulated networks and more volatile, cyclical unregulated activities.

In particular, we assess the creditworthiness of Hera's water networks in accordance with the Rating Methodology for Regulated Water Companies published in December 2009. We use the Regulated Electric and Gas Networks

Methodology, published in November 2014, for Hera's electricity and gas networks; the Environmental Services and Waste Management Methodology, published in June 2014, for Hera's waste division and our Unregulated Utilities Methodology, published in October 2014, to assess Hera's electricity and gas downstream business.

Given its public shareholders' base, the company falls within the scope of our rating methodology for Government-Related Issuers (July 2010; see Credit Policy page on www.moodys.com). However, given the limited capacity of its public shareholders to provide to the company in case of need, our rating does not incorporate any uplift to Hera's standalone credit quality for potential government support.

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