MOODY'S
INVESTORS SERVICE

CREDIT OPINION
5 May 2017

Update

Rate this Research

RATINGS

Hera S.p.A.

Domicile	Italy
Long Term Rating	Baa1
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Alessandra MacDonald 44-20-7772-1771
Analyst
alessandra.macdonald@moodys.com

Raffaella Altamura 44-20-7772-8613
VP-Senior Analyst
raffaella.altamura@moodys.com

Paul Marty 44-20-7772-1036
VP-Sr Credit Officer
paul.marty@moodys.com

Hera S.p.A.

Annual Update

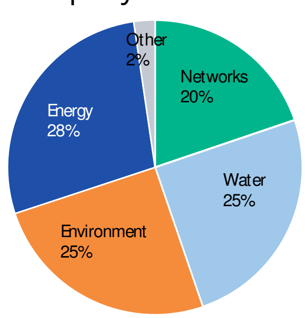
Summary Rating Rationale

The Baa1 rating of Hera S.p.A. ("Hera") is supported by the company's low risk and diversified portfolio of regulated domestic networks (gas distribution, electricity distribution and water services) that account for around 45% of the company's consolidated EBITDA (2016). The residual 55% of Hera's EBITDA comes from unregulated activities (waste management and energy supply businesses) which we view as riskier given their exposure to cyclical macroeconomic trends and to a lesser extent to the continued low power price environment.

More specifically, Hera's rating reflects: (1) the well-established and supportive regulatory frameworks for electricity and gas distribution activities in Italy as well as the positive evolution of the new domestic regulation for water networks; (2) Hera's €2.5 billion investment plan (2016-20) focused on regulated activities (70% of total investments) and sized to maintain some financial flexibility as we expect the company to exhibit an fund from operations (FFO)/net debt of around 18% in 2017-18 (including the effect of potential acquisitions); (3) the company's credit-friendly strategy of external growth, based on small-scale acquisitions funded through exchange of shares; and (4) Hera's good liquidity profile.

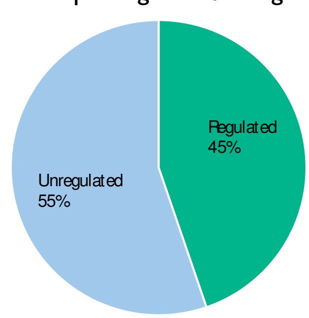
However, the rating also takes account of: (1) Hera's vulnerability to the still challenging sovereign conditions in Italy (Baa2, negative); (2) the exposure of its unregulated businesses to cyclical macroeconomic environment and increased competitive pressure as far as the energy business is concerned; and (3) the exposure, albeit limited, of its unregulated energy and waste activities to a continued low power price environment.

Exhibit 1
EBITDA Split by business



Source: Hera 2016 Results, Moody's estimates

Exhibit 2
EBITDA Split Regulated/Unregulated



Regulated activities include: (i) Electricity distribution; (ii) Gas distribution; and (iii) Water distribution.
Source: Hera 2016 Results, Moody's estimates

Credit Strengths

- » Diversified portfolio of low risk domestic regulated networks with limited price and volume exposure
- » Investment plan pointing to unchanged leverage by 2020 and seized to maintain financial flexibility
- » Good operating performance and resilient credit metrics
- » Credit-friendly strategy of external growth
- » Good liquidity profile

Credit Challenges

- » Exposure to Italy (Baa2, negative)
- » Exposure of unregulated businesses (waste management and energy supply) to cyclical - and currently challenging - macroeconomic environment
- » Continued low power price environment puts pressure on the profitability of the energy generation segment and waste management activities, although the exposure is limited
- » Liberalisation of the retail electricity supply market in Italy from July 2019 likely to increase competition which may create some pressure on Hera's energy business revenues and/or margins

Rating Outlook

The negative outlook on Hera's rating is in line with the outlook on the Government of Italy's (Baa2, negative) rating reflecting the company's linkages with the sovereign given that all its earnings are generated in Italy.

Factors that Could Lead to an Upgrade

- » Given the negative outlook, an upgrade of Hera is currently unlikely. Upward rating pressure would be conditional on a continued improvement of the company's financial profile resulting in funds from operations (FFO)/net debt ratio comfortably in the twenties and retained cash flows (RCF)/net debt at least in the high teens in percentage terms, continued solid liquidity profile and stable business risk profile. A potential upgrade would also be conditional on an upward movement of the Italian sovereign rating.

Factors that Could Lead to a Downgrade

- » Weakening of the company's financial profile to levels permanently below the ratio guidance discussed above e.g. FFO/net debt ratio falling below the upper teens and RCF/net debt ratio below the low teens in percentage terms
- » Hera's growth strategy resulting in a deterioration of its business risk profile with no offsetting strengthening of its credit metrics
- » Any adverse regulatory development, any discriminatory fiscal measures and/or adverse political interference that were to materially affect Hera's regulated businesses
- » Downward movement in the Italian government's rating, particularly if associated with a deterioration of the domestic macroeconomic environment

Key Indicators

Exhibit 3

	2016	2015	2014	2013	2012
(FFO + Interest Expense) / Interest Expense	6.2x	5.4x	5.0x	4.4x	4.5x
FFO / Net Debt	19.9%	18.1%	18.3%	15.5%	15.6%
RCF / Net Debt	15.0%	13.4%	13.8%	11.2%	11.1%
FCF / Net Debt	5.2%	2.1%	2.1%	1.4%	-6.1%

All ratios are based on Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations
Source: Moody's Financial Metrics

Detailed Rating Considerations

Sizeable and diversified portfolio of regulated activities supports stability of revenues and visibility over future cashflows

Hera's gas, electricity and water distribution activities account for approximately 45% of the company's EBITDA (2016) and are fully regulated by the "Autorità per l'energia elettrica, il gas e il sistema idrico" (AEEGSI) through similar capital remuneration and cost recovery mechanisms. The regulatory frameworks applicable to Italian energy and water distribution networks is stable and transparent supporting the predictability of Hera's revenues and the visibility over its future cashflows. The regulations also leave the company exposed to little or no volume risk.

Hera's water services account for 25% of the company's consolidated EBITDA (2016).The second regulatory period (Metodo Tariffario Idrico (MTI)-2) for water distribution activities started in January 2016 and extends over four years with two interim periods (2016-17 and 2018-19). Under the MTI-2 regulation (which is based on principles of continuity vs. MTI-1 and vs. 2012-13 transitory tariff framework), water tariffs stem from a RAB-based, cost recovery mechanism analogous to the well-established frameworks that the AEEGSI applies to Italy's electricity and gas transmission and distribution networks. Whilst recognising the supportiveness and the positive evolution of the regulation for water services in Italy we also note that it will take time for a track record of stable regulatory implementation to be established.

Hera's electricity and gas distribution networks account for approximately 20% of Hera's consolidated EBITDA (2016). Gas distribution networks started a 6-year tariff cycle in 2014 (2014-2019), confirming existing regulatory mechanisms. The WACC for gas distribution activities for the period 2016-2018 stands at 6.1% (down from previous 6.9%, mainly reflecting declining interest rates). In 2016, the process for the re-organisation of Italian gas distribution districts kicked-off (although at a slower than expected pace). Hera intends to participate in tenders where it is already the incumbent operator, thus limiting potential execution risk. In its 2016-20 business plan, the company allocated approximately €330 million for gas tenders which should translate, under management estimates, in additional €30 million of EBITDA by the end of the plan.

Exhibit 4

Summary of regulatory frameworks for Hera's water, electricity and gas distribution network activities

	Water distribution	Electricity distribution	Gas distribution	Comment
Regulatory body	AEEGSI	AEEGSI	AEEGSI	
Start of regulatory period	Jan-16	Jan-16	Jan-14	
End of regulatory period	Dec-19	Dec-23	Dec-19	
Length of regulatory period	4-year period divided in two interim periods (2016-17 and 2018-19)	8-year period divided in two interim periods (2016-19 and 2020-23)	6-year period divided in two interim periods (2014-16 and 2017-19)	
Regulatory framework	Return on RAB, price cap	Return on RAB, price cap	Return on RAB, price cap	
Incentives	Incentives on quality of service provided	Incentives on investments and quality of service provided	Quality of service incentives	
Volume exposure	No exposure. Ex post volume correction	No exposure. Ex post volume correction	No exposure. Ex post volume correction	
RAB calculation	Re-evalued historical cost	Re-evalued historical cost	Re-evalued historical cost	RAB adjusted for inflation annually
Allowed return on capital	5.30%	5.60%	6.10%	real pre-tax
Next rewiew of allowed return on capital	Dec-17	Dec-18	Dec-18	WACC interim review for gas and electricity distribution effective from 2019 respectively (update of risk free rate, inflation, tax rate and country risk premium parameters). Beta and regulatory gearing updated as part of the sector interim or full regulatory review. Option to update water distribution allowed return on capital if material changes occur.
Time lag on investments/D&A	2 years (investments and D&A)	1 year on investments, 2 years on D&A	1 year	
Time lag compensation on WACC	1%	0%	0%	

Source: Moody's on AEEGSI

Exposure of energy supply and waste management businesses to cyclical macroeconomic conditions, mitigated by Hera's entrenched market position in waste management

We estimate that around 23% of Hera's consolidated EBITDA (2016) comes from natural gas and electricity sales and trading businesses. We consider these activities as riskier as they expose the company to the cyclical, and currently challenging, macroeconomic environment.

In the gas segment, Hera has a significant presence with approximately 2.2 bcm of gas sold (2016) to retail, industrial and commercial customers. Hera's short gas procurement strategy is advantageous in times of declining commodity price environment as it aligns the company's cost-revenue structure. Approximately 49% of Hera's gas sales are linked to regulated retail tariffs, which are set by the AEEGSI and are linked to gas spot prices. The remaining 51% of gas volumes are sold in the liberalised market where retail prices are also generally determined in relation to reference market prices or indices. However, Hera's energy retail segment remains exposed to volume fluctuations, and, over the intermediate term, to the risk that market developments might make it more challenging to match positions in sales and procurement. Energy division's profits could also be affected by increased market competition (which the company expects will absorb around €30 million of EBITDA over the years of plan) particularly in the electricity supply segment (9.6TWh of electricity sold in 2016) as regulated electricity retail tariffs are due to be phased out starting from July 2019. Nevertheless, at least over the next two years, we expect the Energy division EBITDA to be supported by the contracts for safeguarded customers in electricity and default gas that Hera was awarded for the period 2017-18 which should bring around €40 million of additional EBITDA.

As for Hera's environment division (25% of 2016 consolidated EBITDA), a fragmented and under-dimensioned waste treatment market increases the potential for Hera to reach its special waste volume target of 3.2 million tonnes (from 2.3 million tonnes in 2016), raising its market share in the north-eastern regions and capturing part of the infra-regional waste flows from southern and central Italy. In line with its strategy of vertical integration and expansion, in April 2017 Hera acquired 40% of Aliplast (around €35 million paid), a company focused on the collection and production of plastic from recycled material, which is expected to bring additional 80k tonnes per year (around €15 million of EBITDA). A further 40% will be acquired by March 2018 and the residual by June 2022. 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 that the latter are partly mitigated by Hera's regulated collection activities (around one-third of Hera's waste division EBITDA) which rely on a solid urban waste collection base and which represents a natural upstream contributor to waste treatment activities. Collection activities in Italy are performed under concessions assigned through tenders. Between 2017 and 2019 around two-thirds of Hera's concessions will be re-tendered, exposing the company to a significant risk of volumes' loss. However, as incumbent operator, we expect Hera to be able to leverage on its knowledge of the territory and on its scale to offer increased service efficiency and confirm its existing presence. Moreover, the introduction of a new regulatory framework for waste collection activities by the AEEGSI, as provided under the Madia Law, could benefit the predictability of Hera's revenues (and potentially also collection margins), if implemented under principles similar to those currently applied to more established regulated networks (e.g. gas and electricity transmission and distribution and water services). Nevertheless, there is still uncertainty around the exact timing of its implementation. Hera's waste business exposure to macroeconomic cycle is also mitigated by evidence of capacity constraints for the Italian waste treatment market and by its WTE plants fleet given its very high load factors (we estimate that the WTE plants' weighted average load factor in 2016 was around 77%) and its incentivised electricity and thermal production. In 2016, around 56% of Hera's electricity production was incentivised but we expect the latter to decline to around 24% by 2020.

Some exposure, albeit limited, to continued low power prices environment

Hera's energy activities are exposed to the continued low power prices in Italy, although such exposure is limited by the small weight of its generation activities. The majority of Hera's generation capacity is attributable to its waste-to-energy (WTE) and biogas/biomass plants (155MW installed capacity, and around 1TWh of electricity production), whose profitability is principally driven by waste incineration and incentives on electricity production. Whilst Hera's WTE electricity production has limited exposure to changes in the company's waste volumes given the significantly smaller treatment capacity (approximately 1.3 million tonnes) relative to Hera's total commercialised waste volumes (4.4 million tonnes in 2016) we note the expiry of green certificates incentives for €15 million between 2017-20 (in addition to the €15 million already matured in 2016).

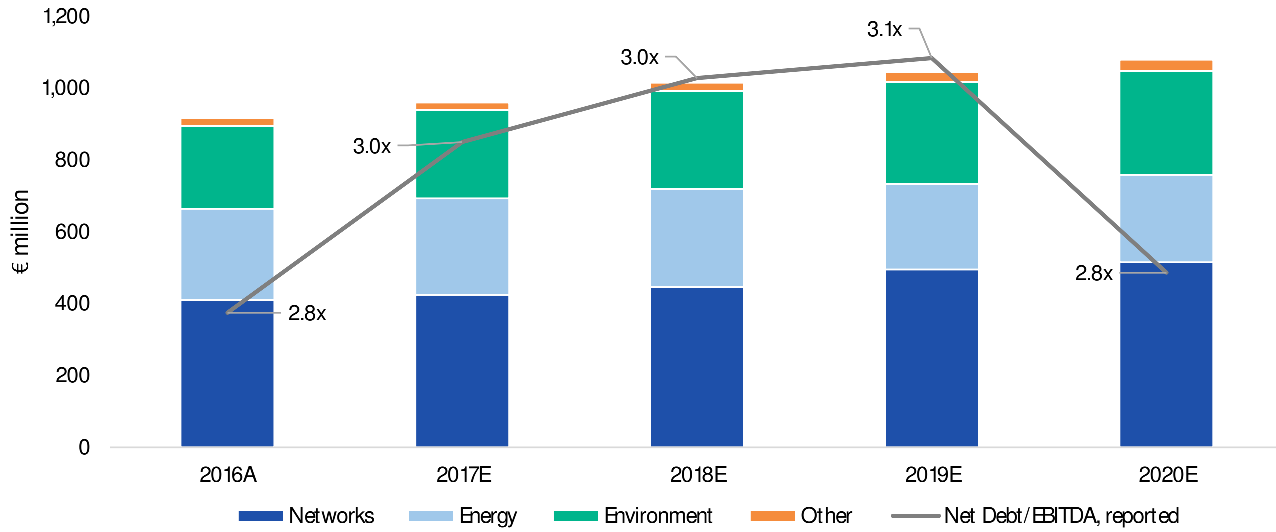
Good operating performance and plan focused on growth and flat leverage support Hera's financial flexibility

In 2016, Hera's consolidated EBITDA rose by 3.6% year-on-year despite some negative one offs such as the reduction in rate of return on regulated networks and the expiry of green certificates incentives that, together, reduced 2016 consolidated EBITDA by €48 million (vs. 2015). The most significant contribution to growth came from the energy division (+18% year-on-year) supported by the increase in energy supply margins (which also benefitted from French nuclear outages) and by the positive performance of the energy generation activities on the dispatching market.

Hera's business plan, presented in January 2017, targets an EBITDA of €1.08 billion by 2020 (+4.2% CAGR) underpinned by almost €2.5 billion of investments between 2016-20, of which 70% directed to regulated activities (including the investments for gas tenders). The plan is overall consistent with that of the previous year and is mainly supported by Hera's organic growth and small scale M&A. Leverage is expected to peak between 2018-19 as the net debt/EBITDA (under management case) will reach 3.0x-3.1x, driven by higher capex but also reflecting the effects of the full consolidation of the debt coming from potential M&A targets.

Exhibit 5

Hera's business plan 2016-20: EBITDA growth (+4.2% CAGR) and net debt/EBITDA evolution



Note: Networks include (i) gas distribution networks; (ii) electricity distribution networks; and (iv) water services
Source: Hera 2016-2020 Business Plan, Moody's

If successfully executed, Hera's new plan would support its current rating positioning. However, we note 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.

We expect the company to exhibit an FFO/Net debt ratio of around 18% and an RCF/Net debt ratio of 13-14% in 2017 and 2018. These metrics would leave Hera adequately positioned against the ratio guidance for the Baa1 rating. We note that our expectations are based on a more conservative evolution of Hera's Environment and Energy divisions vis-à-vis Hera's plan targets as well as on the execution of some M&A transactions.

Consolidation strategy remains credit friendly

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, favoring the execution of a balanced financial policy over the years, based on growth through small share-swap acquisitions, contained leverage and a stable dividend policy.

Hera's external growth strategy historically resulted in the extraction of significant synergies from the acquired entities (approximately €4 million achieved in 2016). The company targets to achieve a further €17 million synergies by 2020 resulting from operations already been acquired and operations to be acquired.

Liquidity Analysis

As of December 2016, Hera exhibits a strong liquidity profile, backed by €352 million of cash and cash equivalents and €445 million of committed credit lines (completely undrawn). Almost 40% these facilities will remain available for withdrawal until the end of December 2017, with the residual expiring between 2018 and 2020. All the committed lines benefit from the absence of any financial covenant and material adverse change (MAC) clauses.

As of December 2016, Hera's reported gross debt amounted to €3.1 billion (vs. €3.4 billion in December 2015), with an average cost of debt of 3.7% and an average maturity of approximately 8 years. Hera does not exhibit any refinancing risk in the next 12 months. The next relevant maturity will be in 2019 when a €395 million bond will expire. Approximately 16% of Hera's debt is exposed to floating interest rates.

Exhibit 6

We expect Hera's total cash available to cover the company's main liquidity needs, over the next 12 months (at December 2016 year-end)

Source: Moody's based on management case

Corporate Profile

Hera S.p.A. is one of the largest multi-utilities in Italy. 51.3% of Hera's shares are currently held by 118 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 in the North-East of Italy. 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 2016, Hera reported consolidated revenues of €4,460 million and an EBITDA of €917 million. Hera is listed on the Milan stock exchange with a market capitalization of around €3.9 billion.

Rating Methodology and Scorecard Factors

There is no single rating methodology for Hera given the group's diversified portfolio of businesses. We assess the creditworthiness of Hera's water networks in accordance with the rating methodology for Regulated Water Utilities published in December 2015. We use the rating methodology for Regulated Electric and Gas Networks, published in March 2017, for Hera's electricity and gas networks and the Environmental Services and Waste Management methodology, published in June 2014, for Hera's waste division, and the rating methodology for Unregulated Utilities, published in October 2014, for Hera's electricity and gas business.

Given its public shareholders' base, Hera also falls within the scope of our rating methodology for Government-Related Issuers, published in October 2014. However, given the limited capacity of its public shareholders to provide support to the company in a scenario of financial distress, our rating does not incorporate any uplift to Hera's standalone credit quality for potential government support.

Ratings

Exhibit 7

Category	Moody's Rating
HERA S.P.A.	
Outlook	Negative
Issuer Rating -Dom Curr	Baa1
Senior Unsecured	Baa1

Source: Moody's Investors Service

REPORT NUMBER 1064007

Contacts

Alessandra MacDonald 44-20-7772-1771
Analyst
alessandra.macdonald@moodys.com

Paul Marty 44-20-7772-1036
VP-Sr Credit Officer
paul.marty@moodys.com

Raffaella Altamura 44-20-7772-8613
VP-Senior Analyst
raffaella.altamura@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S INVESTORS SERVICE