

CREDIT OPINION

1 June 2016

Update

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RATINGS

Hera S.p.A.	
Domicile	Italy
Long Term Rating	Baa1
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

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.

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Hera S.p.A.

Annual update

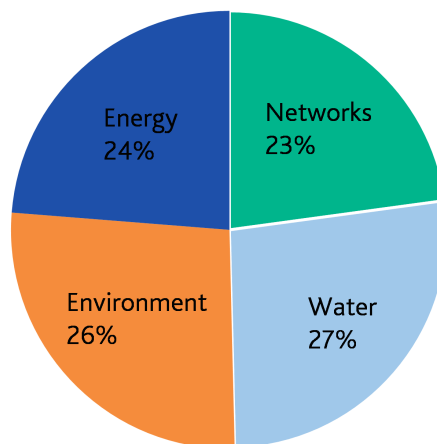
Summary Rating Rationale

Hera's Baa1 rating reflects the company's diversified business mix and the low business risk profile of its regulated activities, which include the operation of gas and electricity networks and water services covering over two million customers in the wealthy North-East of Italy and account for approximately 48% of consolidated EBITDA in 2015.

Hera's rating also factors in (1) Hera's 2015-19 industrial plan focused on regulated activities and sized to maintain a good financial flexibility, which should allow Hera's fund from operations (FFO)/net debt to consolidate in the upper teens; (2) the company's credit-friendly external growth model, aimed at small-target acquisitions through stock-for-stock, synergy-generating mergers; and (3) strong liquidity, with limited refinancing needs for the next two to three years.

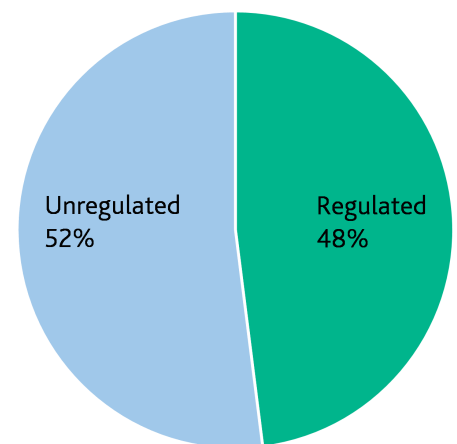
However, the rating also takes account of (1) a still fragile domestic economy; and (2) the company's limited exposure to a continuing decline in commodity prices affecting principally its unregulated waste activities.

Exhibit 1
EBITDA Split by business



Source: Hera 2015 Results, Moody's estimates

Exhibit 2
EBITDA Split Regulated/Unregulated



Source: Hera 2015 Results, Moody's estimates

Credit Strengths

- » Diversified business mix and sizeable presence in regulated activities
- » Investment plan pointing to moderate deleverage and unlikely to challenge Hera's financial flexibility
- » Good operating performance and resilient credit metrics
- » Sector consolidation strategy remains credit friendly

Credit Challenges

- » Some exposure to weak macroeconomic conditions, mitigated by Hera's entrenched market position in waste management
- » Low power prices puts pressure on profitability of the energy generation segment, although the exposure is limited

Rating Outlook

We maintain a stable outlook on Hera's ratings as we expect Hera to maintain credit metrics comfortably positioned within the following bands: FFO/net debt positioned at least in the upper teens in percentage terms and RCF/net debt in the low teens.

The stable outlook on Hera's ratings is also in line with our outlook on Italy's sovereign rating.

Factors that Could Lead to an Upgrade

- » Continued improvement of the company's financial profile resulting in FFO/Net Debt comfortably in the twenties and RCF/Net Debt at least in the high teens, and
- » Further improvement in the domestic macroeconomic scenario as captured by an upward movement of Italy's 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 falling below the upper teens and RCF/Net Debt below the low teens
- » Downward movement in the Italian government's rating
- » Any adverse regulatory development, any discriminatory fiscal measures and/or adverse political interference were to materially affect Hera's regulated businesses
- » The company's liquidity profile were to deteriorate materially
- » Hera's growth strategy resulting in a significant deterioration of its credit profile, either in terms of business mix or leverage

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Key Indicators

Exhibit 3

Key Indicators¹

	2015	2014	2013	2012	2011
(FFO + Interest Expense) / Interest Expense	5.4x	5.0x	4.4x	4.5x	4.2x
FFO / Net Debt	18.1%	18.3%	15.5%	15.6%	15.8%
RCF / Net Debt	13.4%	13.8%	11.2%	11.1%	10.7%
FCF / Net Debt	2.0%	2.1%	1.4%	-6.1%	-3.2%

1) All ratios are based on Adjusted¹ financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations
Source: *Moody's Financial Metrics*

Detailed Rating Considerations

DIVERSIFIED BUSINESS MIX AND SIZEABLE PRESENCE IN REGULATED ACTIVITIES PROVIDE GOOD VISIBILITY TO CASHFLOWS

Approximately 48% of Hera's EBITDA is attributable to regulated energy and water networks, which are supported by stable and predictable regulatory frameworks developed by the same independent body, Italy's Regulatory Authority (AEEGSI), under similar cost recovery and capital remuneration models, which imply no or little volume risk for Hera.

Water services account for 26% of the company's consolidated EBITDA (2015). The new regulatory framework for water services (Metodo Tariffario Idrico -2) is credit supportive and is generally based on principles of continuity with the previous regulatory periods. Water networks tariffs follow a RAB-based, cost recovery mechanism analogous to the established framework that AEEGSI applies to regulate Italy's electricity and gas T&D networks.

Electricity and gas distribution networks account for approximately 22% of Hera's consolidated EBITDA (2015). Gas distribution networks started their n 6-year tariff cycle in 2014, confirming existing regulatory mechanisms. In December 2015 the AEEGSI reduced the WACC of gas distributions for the 2016-208 period to 6.1%, from 6.9%, mainly reflecting declining interest rates. Starting from 2016, 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 intends to participate in tenders where it is already the incumbent operator. The company has earmarked approximately €300 million for the completion of its existing gas network perimeter.

SOME EXPOSURE TO WEAK MACROECONOMIC CONDITIONS, MITIGATED BY HERA'S ENTRENCHED MARKET POSITION IN WASTE MANAGEMENT

Hera's energy activities remain exposed to the current downward trend for electricity prices in Italy, although the exposure to wholesale electricity prices is limited by the small weight of its generation activities. The majority of Hera's generation capacity is in fact attributable to its waste-to-energy (WTE) and biogas/biomass plants (155MW 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 we estimate to account for 14% of its EBITDA in 2015 (2.1 bcm sold to retail, industrial and commercial customers, vs. 1.8 bcm the year before). Hera's short gas procurement strategy has proven advantageous in a declining commodity price environment. The typical risks associated with a short position are more muted given the features of the Italian energy supply market. Approximately 40% of gas sales are linked to regulated retail tariffs, which are set by the AEEGSI and are linked to gas spot prices. The remaining 60% of gas volumes are sold in the liberalised market and in the separately regulated "salvaguardia" electricity market, where, again, retail prices are generally determined in relation to reference market prices or indices. Whilst the level of competition is currently relatively low, Hera's energy retail segment remains exposed to volume fluctuations and, over the intermediate term, the risk that market developments might make it more challenging to match positions in sales and procurement (e.g. regulated electricity retail tariffs are due to be phased out starting from 2018).

As for Hera's environment division (26% of 2015 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 2.0 million tonnes in 2015), 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 this strategy Hera acquired in December 2015 Waste Recycling, a waste treatment plant in the Tuscany region, and the waste assets of Geonova, a medium sized company based in the North East of Italy, which in 2015 together treated approximately 520k tonnes of special waste. 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; and (3) evidence of capacity constraints for the Italian waste treatment market. Moreover, Hera's WTE plants 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.

RESILIENT PERFORMANCE IN 2015 AND NEW PLAN FOCUSED ON GROWTH AND MODERATE DELEVERAGE SUPPORT HERA'S FINANCIAL FLEXIBILITY

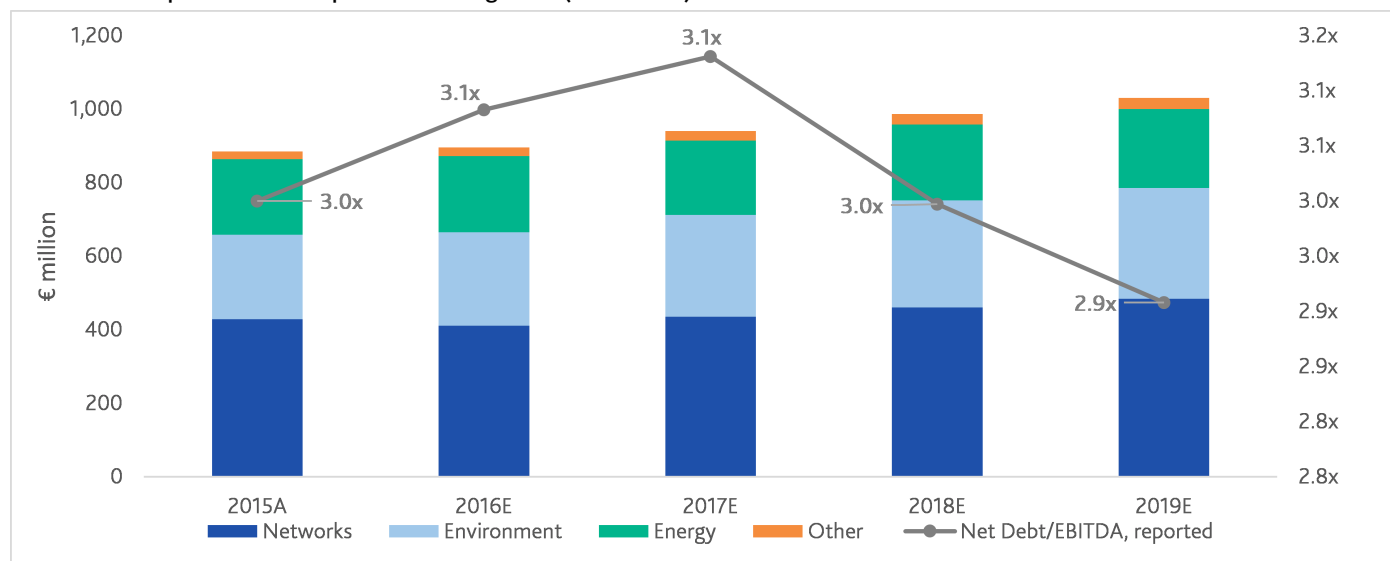
EBITDA rose 1.9% year-on-year to €884.4 million in 2015. The most significant contribution came from the water division (+7.1% year-on-year), mostly driven by tariff increases and gas division (+7.2% year-on-year), mainly driven by recovering gas consumption. This was partially compensated by a reduction in waste EBITDA (-4.9% year-on-year) mainly due to shortage of landfill capacity constraining volumes, although we note that capacity expansion is underway. Hera reported a positive evolution of its financials in Q1 2016 with EBITDA rising 0.4% despite the lower rate of return on regulated activities, mainly thanks to higher retail margins and higher ancillary services revenues compared to Q1 2015.

Reported 2015 net debt remained in line with last year (+0.4% year-on-year), amounting to €2.65 billion after €333 million capex, a €142 million dividend, €67 million acquisitions and €557 million operating cash flows. That ultimately translated in broadly stable credit metrics, as FFO/Net Debt was 18.1% (18.3% in 2014) and RCF/Net Debt was at 13.4% (13.8% in 2014). The company's reported Net Debt/ EBITDA in 2015 remained 3.0x. We note that 2015 metrics do not yet incorporated the expected positive contribution from the waste activities acquired in December 2015.

HERA's business plan, presented in January 2016, targets EBITDA of €1 billion by 2019 (+4.4% CAGR) through a €2.2 billion of capex programme, of which 73% concentrated in regulated activities. The plan is consistent with that of the previous year and mainly supported by Hera's organic growth and small scale M&A. The plan implies a moderate deleverage from 3.0x to 2.9x Net Debt/EBITDA by 2019.

Exhibit 4

Hera's business plan 2015-19: expected EBITDA growth (+4% CAGR) and Net Debt/EBITDA evolution



Source: Hera 2015-2019 Business Plan

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.

We expect the company to exhibit a FFO/Net debt ratio of 17%-18% and a RCF/Net debt ratio of around 13-14% in 2016 and 2017. These metrics would leave Hera adequately positioned within its Baa1 guidance. We note that our expectations do not incorporate any future acquisition, which instead could have positive effects on Hera's leverage if executed through a share swap, and assume, inter alia, a more conservative evolution of Hera's Environment and Energy divisions vis-à-vis Hera's plan targets.

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, favouring 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. The €67 million acquisitions completed in 2015 (including Waste Recycling and GeoNova in December 2015) were self-financed with cash generated, remaining consistent with the company's prudent consolidation strategy.

Hera's external growth strategy historically resulted in the extraction of significant synergies from the acquired entities (€15 million achieved until 2014). The company targets to achieve a further €21 million synergies by 2019 from operations that have already been acquired.

Liquidity Analysis

As of December 2015, Hera exhibits a strong liquidity profile, backed by €541 million of cash and cash equivalents and €445 million of committed credit lines (completely undrawn). Approximately 40% these facilities will remain available for withdrawal until the end of December 2017, with the remainder expiring between 2018 and 2020. All the committed lines benefit from the absence of any financial covenant and material adverse change (MAC) clauses.

At the end of 2015, Hera's reported gross debt amounted to €3.4 billion, 69% of which will expire beyond 2019, with an average maturity of 8 years. Hera does not exhibit any refinancing risk in the next 12 months. The next relevant maturity will be in 2019 when a €500 million bond will expire. Approximately 17% of Hera's debt is exposed to floating interest rates.

Corporate Profile

Hera S.p.A. is one of the largest multi-utilities in Italy. Almost 51.9% of Hera's shares are currently held by 118 municipalities (public shareholders), the largest of which is the City of Bologna, which owns approximately 13% 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 2015, Hera reported consolidated revenues of €4,818 million and an EBITDA of €884 million.

Rating Methodology and Scorecard Factors

In particular, we assess the creditworthiness of Hera's water networks in accordance with the Rating Methodology for Global Regulated Water Companies published in December 2015. 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 (October 2014; see Credit Policy page on www.moody's.com). 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 5

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

Source: Moody's Investors Service

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