MOODY'S
INVESTORS SERVICE

Credit Opinion: HERA S.p.A.

Global Credit Research - 27 Jul 2011

Bologna, Italy

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating -Dom Curr	A3
Senior Unsecured	A3

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Key Indicators

HERA S.p.A.

	2010	2009	2008
(FFO + Interest Expense) / Interest Expense	**4.3x**	**4.6x**	**3.8x**
FFO / Net Debt	**15.1%**	**13.5%**	**15.5%**
RCF / Net Debt	**10.8%**	**9.3%**	**10.6%**
FCF / Net Debt	**-3.2%**	**-12.6%**	**-9.1%**

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

Opinion

Corporate Profile

Hera S.p.A. ("Hera", rated A3, stable outlook) is one of the largest integrated multi-utilities in Italy, formed through the merger of 11 local utilities in the Emilia Romagna region in 2002. Since June 2003, Hera has been listed on the Italian stock exchange, but a majority of its shares remain in public hands. Overall, approximately 60% of Hera's shares are held by 189 different municipalities in the Emilia Romagna region (of which 51% restricted by a shareholders' agreement), the largest of which - the City of Bologna - owns approximately 15% of the company.

Following the merger with another local utility, Meta S.p.A., in November 2005, the Hera group covers 70% of the Emilia Romagna area, which is located in central-north Italy and is one of the most populous and wealthiest regions in the country.

Hera's service area encompasses the provinces of Bologna, Ferrara, Forli-Cesena, Imola-Faenza, Modena, Ravenna and Rimini, where the group provides a variety of public services, including the sale and distribution of gas and electricity, the provision of integrated water services, urban and special waste collection and disposal services, as well as ancillary activities, such as district heating and public lighting.

Rating Rationale

Hera's A3 rating is underpinned by its low business risk profile and the diversified portfolio of its regulated activities, accounting for approximately 50% of consolidated EBITDA. These businesses, characterised by quasi-monopoly features and based on long-term concessions, provide a good degree of predictability and visibility to the company's earnings. Hera's rating also factors in the company's exposure to unregulated operations, mainly comprising the operation of landfills, waste-to-energy ("WTE") plants, as well as supply of gas and electricity, district heating and public lighting activities. Whilst recognising the recent improvement in the company's financial profile, Hera's credit metrics are weakly positioned for the current A3 rating. Failure to further strengthen its financial profile would potentially result in negative rating pressure.

DETAILED RATING CONSIDERATIONS

In light of Hera's majority ownership by a number of Italian municipalities, of which the City of Bologna is the largest with 15%, the company falls within the scope of Moody's rating methodology for government-related issuers ("GRIs"), which was updated in July 2010. In accordance with this rating methodology, the company's A3 rating reflects the combination of the following components:

- Credit risk profile of Hera on a stand-alone basis, known as the Baseline Credit Assessment ("BCA"), of "7" (on a scale of 1 to 21, where 1 represents the lowest credit risk), which is equivalent to the "A3" rating category;

- Moody's assessment of the credit quality of Hera's municipal shareholders, with the City of Bologna rated Aa2, under review for downgrade;

- Moderate dependence, reflecting that (i) the majority of the company's revenues are generated from a wider area in the Emilia Romagna region, and (ii) the majority of the factors that are likely to affect Hera's business and financial performance are unlikely to impact the City of Bologna's credit quality, and vice versa;

- Low support, reflecting the relatively small individual stake of the various municipalities and the large size of the company relative to the City's and the other municipalities' financial capacity. Under the company's by-laws and the terms of the shareholder agreement signed by Hera's municipal shareholders, at least 51% of the company's share capital must remain under municipal ownership. Similarly to the other municipal shareholders, the City of Bologna has some material interests in Hera, both as shareholder and in relation to the quality of services provided within its territory. However, Moody's believes that it is unlikely that the City would be willing or able to provide extraordinary support to Hera in the event of a financial crisis, without a concerted effort by the other shareholders.

As a result of these parameters, Hera's A3 rating currently does not incorporate any uplift from its stand-alone credit quality for potential government support.

Baseline Credit Assessment

When assessing Hera's BCA, the following factors represent key drivers in determining the rating.

ASSESSMENT OF BUSINESS RISK PROFILE

Hera's business risk profile is underpinned by the company's diversified portfolio of regulated utility businesses, which account for approximately half of consolidated EBITDA, predominantly comprising water and waste water services, gas and electricity distribution as well as solid urban waste activities. These businesses are characterised by quasi-monopoly features based on long-term concessions, generating stable returns set by the relevant Regulators at periodic reviews, which provide a good degree of predictability and visibility for a large portion of Hera's cash flows. Nevertheless, Moody's notes that Hera remains in principle exposed to renewal risk over its concession activities, with renewal procedures currently untested, although this risk is mitigated by the company's scale and position as the incumbent operator and the portfolio effect resulting from holding several concessions in different sectors.

With regard to Hera's regulated water operations (accounting for approximately 23.4% of EBITDA), Moody's notes the potential regulatory uncertainties associated with the outcome of a recent referendum consultation, which resulted in the removal of the reference to the "adequate remuneration of investments" (currently 7% real pre-tax) included in the water-tariff calculation under the existing framework. Whilst Moody's understands that the change in the investments remuneration formula is unlikely to be extended to capital expenditure either finalised or in the course of being undertaken, the current lack of clarity regarding the extent of the application of these regulatory changes could potentially create some uncertainties in the context of Hera's future investment plans and regulatory price reviews. More generally, Moody's believes that the removed reference to the adequate remuneration of investments included in the current framework would need to be replaced by alternative legislation and remuneration parameters, in order to support essential investments in the sector, which could otherwise be postponed in light of the lack of visibility surrounding remuneration settings. Whilst this could potentially support the long-awaited reform of Italian water regulation and the drive for creating a central national water regulatory body, the timing associated with the implementation of any alternative legislation and remuneration parameters remain uncertain at this stage.

Hera's rating also factors in the company's exposure to unregulated operations, which contribute just under 50% to consolidated EBITDA, comprising waste treatment and WTE, supply of gas and electricity, district heating and public lighting activities.

Waste treatment and WTE plants are expected to be the main contributors to the company's growth over 2010-14, underpinned by Hera's strong competitive position in the segment. Electricity and gas supply activities are characterised by relatively low margins and higher risk, given Hera's exposure to the development of competition and the company's short upstream position, partially mitigated by planned investments in additional generation capacity and equity gas positions. Whilst technically non regulated, Moody's notes that district heating and public lighting operations are characterised by higher stability, benefiting from long-term contractual arrangements and customer lock-in.

Hera's risk profile benefits from the favourable economic and demographic characteristics of its service area, which is one of Italy's wealthiest regions. The rating also takes into account as positive factors Hera's good service performance, demonstrated by low water leakage and high environmental compliance.

ASSESSMENT OF FINANCIAL RISK PROFILE

Hera's investment plan for 2010-14 includes around EUR1.7 billion of capex, of which approximately 58% is related to development initiatives and 42% to maintenance. The bulk of projected expenditures are concentrated on the water and gas network activities (55%), with capex aimed at optimising sourcing and expanding the network, and the waste segment (32%), where Hera aims to complete WTE projects under development and expand the special waste business segment. As part of its plan, Hera also intends to strengthen its energy activities, with the strategic objective of increasing upstream integration, enlarging its customer base and expanding its district heating network.

Whilst Hera has indicated that funding of the investment programme for 2010-14 is expected to be fully covered by internally generated operating cash flows, Moody's believes that cash flow generation will strengthen only gradually as new assets come on stream and the operating environment, particularly in the waste segment, recovers.

With FFO/Net Debt of 15.1% and RCF/Net Debt of 10.8% as of YE2010, Hera's financial profile is currently for the A3 rating category. Moody's would expect Hera to exhibit an FFO Interest Coverage ratio of at least 4.0x, FFO/Net Debt at least in the high-teens and RCF/Net Debt above 12% on a sustainable basis to support the current rating. This ratio guidance recognises the company's business risk positioning, underpinned by Hera's continued presence in the low risk regulated businesses, which are expected to continue to generate approximately half of the consolidated EBITDA in the medium term. Moody's cautions that failure to recover its financial profile generally in line with the ratios guidance above would potentially result in negative rating pressure.

Whilst noting that Hera does not exclude M&A transactions, Moody's cautions that current ratings do not incorporate the assumption of future acquisitions.

Liquidity

Hera's liquidity profile is strong. Primary sources of liquidity include the company's operating cash flow generation and significant cash and liquid securities balances, which were approximately EUR537 million as at 31 March 2011. Secondary sources include various committed bilateral lines cumulatively amounting to EUR280 million (undrawn as of 31 March 2011) maturing between December 2011 and June 2014, which benefit from the absence of financial covenants, albeit including rating triggers. Together, these sources are expected to provide sufficient funds to cover payments expected over the next 12 months for capital expenditure, debt repayments and dividends. Of the EUR2.4 billion of debt as of 31 March 2011, approximately EUR118 million matures by March 2012.

Rating Outlook

The stable outlook associated with the rating incorporates the expectation that Hera's financial profile will recover beyond 2010 and that the company will maintain - as it proceeds with the implementation of its investment programme- key credit metrics at levels commensurate with the current rating. Moody's cautions that, should a material strengthening of key credit ratios not to materialise, and/or the company fail to consolidate its capital structure and embark on additional M&A transactions, Hera's rating would come under negative pressure. The stable outlook also includes the expectation that the company will continue to maintain a significant presence in regulated activities in the medium/long-term.

What Could Change the Rating - Up

In light of the current weak positioning of credit metrics and Hera's investment programme over the period 2010-14, Moody's does not envisage any immediate upward rating pressure in the near term.

What Could Change the Rating - Down

Prolonged weakness of the company's financial profile beyond 2010, resulting in FFO Interest Coverage below 4.0x and FFO/Net Debt below the high-teens, as well as the implementation of an overly-aggressive dividend policy, leading to RCF/Net Debt ratios below 12% on a sustainable basis, would result in negative rating pressure. Downward rating pressure could also develop in case of a deterioration of Hera's business risk profile as a consequence of a shift from low-risk domestic regulated activities to higher-risk unregulated activities, as well as a severe deterioration in the risk profile of existing unregulated activities.