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Credit Opinion: Hera S.p.A.

Global Credit Research - 03 Jun 2015

Bologna, Italy

Ratings

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

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Key Indicators

Hera S.p.A.

	2014	2013	2012	2011	2010
(FFO + Interest Expense) / Interest Expense	4.9x	4.3x	4.4x	4.2x	4.3x
FFO / Net Debt	18.0%	15.3%	15.4%	15.6%	14.8%
RCF / Net Debt	13.6%	10.9%	10.9%	10.6%	10.4%
FCF / Net Debt	2.0%	1.4%	-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 provide good visibility to cashflows

- Some exposure to weak macroeconomic conditions, mitigated by Hera's entrenched market position in waste management

- New investment plan points to moderate deleverage and is unlikely to challenge Hera's financial flexibility

- Good operating performance and improving credit metrics

- Consolidation strategy remains credit friendly

Corporate Profile

Hera S.p.A. 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 2014, Hera reported consolidated

revenues of EUR4,189 million and an EBITDA of EUR868 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).

Hera's rating also factors in (1) the deleveraging trajectory implied in Hera's 2014-18 industrial plan, which should allow Hera's fund from operations (FFO)/net debt to consolidate in the upper teens, a level that we see as commensurate with the rating given Hera's risk profile; and (2) evidence of progress towards the these targets following 2014 and Q1 2015 results. Notwithstanding a still weak domestic economy and a continuing decline in energy demand and prices, Hera's resilient business mix profile, together with a successful containment of its financial indebtedness and a material reduction of its corporate tax rate, has resulted in an improvement of the company's credit metrics (2014A: FFO/net debt 18%, retained cash flow (RCF)/net debt: 13.6%).

Furthermore, Hera's rating takes into account 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. Departures from its historically credit-friendly strategy could put downward pressure on the rating. Finally, the rating incorporates Hera's strong liquidity, with limited refinancing needs for the next two to three years.

DETAILED RATING CONSIDERATIONS

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

Approximately 47% 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 models, which imply no or little volume risk for Hera.

Water services account for 25% of the company's consolidated EBITDA (2014). The new regulatory framework for water services is credit supportive. 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 22% 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 the end of 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.

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

The company has instead a more significant presence in natural gas retail sales and gas trading activities, which

together accounted for 12% of its EBITDA in 2014 (1.8 bcm sold to retail, industrial and commercial customers, vs. 2.2 bcm the year before). 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. More recently, the company has also benefited from an improvement in unregulated retail sales margin, mainly consequent to lower procurement costs for gas sales, and from its participation to the separately regulated salvaguardia electricity market.

As for Hera's environment division (28% 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 2.1 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 POINTS TO MODERATE DELEVERAGE AND IS UNLIKELY TO CHALLENGE HERA'S FINANCIAL FLEXIBILITY

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 3.2x (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.

GOOD OPERATING PERFORMANCE AND IMPROVING CREDIT METRICS

2014 results showed a positive evolution of Hera's operating cashflows, underpinned by a +7% year-on-year EBITDA growth and lower corporate taxes following the decrease of the Robin Hood Tax rate to 6.5% (from 10.5%) and the full deductibility of labour costs from IRAP tax. Whilst Hera's EBITDA growth was partially (36% of the increase) due to the share-swap based acquisitions of Isontina Reti, Est Energia and AMGA, their consolidation had a limited effect on Hera's Net Debt evolution, allowing the company to improve its Net Debt/EBITDA from 3.2x to 3.0x (as reported). The deleverage translated into an improvement of Hera's FFO/Net Debt to 18%, from previous year's 15.3%. The positive evolution of Hera's financials continued in Q1 2015, albeit at a slower pace, reflecting also the definitive cancellation of the Robin Hood Tax.

In terms of business mix evolution, Hera's energy division (+6% in 2014 and +19% in Q1 2015, in terms of year-on-year EBITDA growth) compensated for a lackluster trend in Environment business. The latter was impacted in Q1 2015 by the temporary interruption of several of Hera's WTEs, due to extraordinary maintenance, and by the delay in the opening of a new landfill. That affected overall treated volumes, which declined by 8%, to 938,800 tonnes. Energy divisions results benefited from an increase in margins, as a consequence of Hera's short gas and electricity procurement strategy, the contribution of regulated mercato di salvaguardia activities to the division's profits and, in Q1 2015, thanks also to a sharp rebound in sold volumes (1 bcm excluding trading volumes, +27% year-on-year increase). The regulated networks contribution to Hera's operating profits growth was positive in 2014, notwithstanding a reduction in regulatory WACC for gas distribution networks, and in Q1 2015 (+5% on a like for like basis, excluding one-off rebalancing payments in Q1 2014).

Overall, the recent evolution of Hera's operations confirms in our view the resilience of its business model and the benefits of a diversified business mix, as a worse than expected progression in waste activities was compensated by much stronger results in energy retail sales, and the contribution from equity-financed acquisitions added to Hera's operating results with no detrimental effect on its credit metrics.

We expect the company to exhibit a funds from operations (FFO)/net debt ratio of 17%-18% and a retained cash flow (RCF)/net debt ratio of around 13% in 2015 and 2016, crystallizing the improvement on its historical levels. 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 a significant (around 150 basis points) reduction of return on capital allowances for Hera's regulated activities starting from 2016. We also assume no increase in dividend from 2014 levels, a more conservative evolution of Hera's Environment and Energy divisions vis-à-vis Hera's plan targets, a lower tax rate from 2015, and the expectation of a slow reduction of Hera's cost of debt given better market conditions.

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 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.

We also note that the unsuccessful bid for the portfolio of 800,000 gas and electricity supply customers that the German utility E.ON intended to sell, and which was likely to be debt-financed, has eliminated the risk of a significant increase in Hera's exposure to inherently riskier energy downstream activities. That acquisition, which was not included in the company's investment plan, might have signaled a material departure from Hera's credit-friendly consolidation strategy. However, we believe that similar opportunistic acquisitions are unlikely to be targeted in the future.

Liquidity Profile

As of December 2014 Hera exhibits a strong liquidity profile, backed by EUR835 million of cash and cash equivalents and EUR295 million of committed credit lines (completely undrawn). Less than two thirds of these facilities will remain available for withdrawal until the end of December 2017, with the remainder expiring at the end of 2019. All the committed lines benefit from the absence of any financial covenant and material adverse change (MAC) clause.

At the end of 2014, Hera's reported gross debt amounted to some EUR3.7 billion, the bulk of which (more than 75%) will expire beyond 2018, for an average debt duration of approximately 6.5 years. In the next 12 months, some EUR480 million are due for repayment, also including the maturity of a EUR180 million EIB loan (successfully repaid in January 2015). 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 stable outlook on Hera's rating reflects the improvement in Hera's credit metrics to a level commensurate with its current Baa1 rating and the increased financial flexibility, which should allow the company to absorb the consequences of a still weak domestic macroeconomic environment and of a decrease in regulated returns starting from 2016. In order to support the current Baa1 rating, 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.

The stable outlook on Hera's ratings is also in line with our outlook on the Italian government's rating.

What Could Change the Rating - Up

A continued improvement of the company's financial profile to a level exceeding the ratios guidance discussed above (i.e. resulting in an FFO/net debt comfortably in the twenties and in an RCF/net debt at least in the high-teens) and a further improvement of the domestic macroeconomic scenario, as well as of public finances, as captured by an upward movement of Italy's sovereign rating, would be preconditions to a higher rating.

What Could Change the Rating - Down

We would consider downgrading Hera's rating if (1) the company's credit metrics were to persistently fall below the 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 were to result in a significant deterioration of its credit profile, either in terms of business mix or resulting leverage; (3) unfavourable regulatory determinations or political interferences were to materially affect Hera's regulated businesses; (4) a deterioration of the Italian macroeconomic environment were to significantly affect the company's cyclical operations; (5) the company's liquidity profile were to deteriorate 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.

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 http://www.moodys.com for the most updated credit rating action information and rating history.

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