STANDARD & POOR'S

Standard & Poor's Research

Research Update:

Italy-Based Multi-Utility Hera Downgraded To 'BBB' On Sovereign Downgrade, Outlook Stable

Primary Credit Analyst:
Vittoria Ferraris, Milan (39) 02-72111-207; vittoria.ferraris@standardandpoors.com

Secondary Contact:
Tuomas E Ekholm, CFA, Frankfurt (49) 69-33-999-123; tuomas.ekholm@standardandpoors.com

Table Of Contents

Research Update:

Italy-Based Multi-Utility Hera Downgraded To 'BBB' On Sovereign Downgrade, Outlook Stable

Overview

- We recently lowered our unsolicited long-term sovereign rating on Italy, reflecting our view that its economic prospects are further worsening.
- We believe Italy-based Hera's deleveraging efforts could be constrained by weakening prospects in Italy.
- We are therefore lowering our long-term corporate credit rating on Hera to 'BBB' and affirming our short-term rating at 'A-2'.
- The stable outlook reflects our expectation that Hera will achieve and sustain adjusted funds from operations to debt above 18%, while maintaining a high contribution of operating income from lower risk regulated utility activities.

Rating Action

On July 12, 2013, Standard & Poor's Ratings Services lowered its long-term corporate credit and senior unsecured debt ratings on Italy-based multi-utility Hera SpA to 'BBB' from 'BBB+'. At the same time, we affirmed our short-term rating at 'A-2'. The outlook is stable.

Rationale

The downgrade reflects our view that weaker economic and industry conditions in Italy will likely impair Hera's capacity to improve its debt metrics to levels we view as commensurate with the previous rating. Hera's strategy to improve its credit metrics relies essentially on the growth of operating cash flows over the near to medium term. In our base-case scenario, however, we forecast Hera will post negative to neutral cash flow after capital expenditure and dividends over the coming years. In our view, this means Hera has very little room to maneuver and less ability to reduce debt in a further deteriorated economic and industry environment. In our view, the enduring economic pressure in Italy is likely to put pressure on Hera's profitability and cash flow generation.

We believe weaker-than-expected economic conditions in Italy could affect the group through deteriorating payment terms, sustained high tax pressure, and potentially higher funding costs compared with European peers operating in countries with less economic stress. Furthermore, we think that growing pressure to reduce power prices in Italy could negatively affect Hera's margins in electricity supply. A recovery of volumes in Hera's waste segments could in our view take longer than expected in Italy's recessionary environment, even though currently weak economic conditions could reduce competitive pressures in the sector, in which Hera retains a dominant position domestically.

We assess Hera's country risk exposure to Italy as "high" because 100% of its revenues originate from Italian utility operations. Our ratings on these types of utilities are generally constrained by the rating on the sovereign where they are domiciled. Exceptions are those, such as Hera, that have extraordinary credit strength or other characteristics that mitigate domestic risk factors. We believe there is a reasonable likelihood that Hera would be able to withstand a sovereign default. We have stress-tested Hera's business and financial risk profile in a hypothetical Italian default scenario. We believe the utility's ability to service and repay debt is superior to that of the sovereign.

Our 'BBB' long-term rating reflects our view of Hera's business risk profile as "strong" and financial risk profile as "significant." The "strong" business risk profile has been weakening over time, owing to Hera's exposure to Italy country risk, but continues to reflect a significant portion of regulated activities and the capacity to maintain moderate growth in a tough operating and economic environment. Hera's "significant" financial risk profile reflects high financial gearing and relatively weak credit metrics, partly mitigated by Hera's comfortable liquidity position and prudent refinancing policy.

Liquidity

We assess Hera's liquidity as "strong" according to our criteria. In our view, the company will cover its planned cash outlays--mainly capital expenditure, debt service, and dividends--by more than 1.5x over the next 12 months with available cash, committed credit lines as of Dec. 31, 2012, and funds from operations (FFO).

Our assessment is underpinned by the following liquidity sources over the next 12 months:

- Access to unrestricted cash of more than €530 million, mainly held at the parent company level as of March 2013;
- Available committed credit lines of €450 million with a maturity longer than 12 months; and
- Our forecast that Hera will generate annual FFO of about €500 million-€530 million in the next 12 months.

This compares with our forecast of the following liquidity uses over the next 12 months:

- €280 million-€300 million of capital expenditures;
- Dividend outflows of approximately €120 million; and
- Debt maturities of €500 million.

At the same time, under our base-case scenario, we anticipate that Hera will post negative to neutral discretionary cash flows after capital expenditures and dividends over the next two years.

Outlook

The stable outlook on Hera reflects our expectation that it will achieve and sustain adjusted FFO to debt higher than 18%. It also reflects our belief that the Republic of Italy (unsolicited ratings BBB/Negative/A-2) does not fully constrain Hera's creditworthiness at the current rating level.

We could lower the rating if we considered that Hera could struggle to achieve and maintain adjusted FFO to debt exceeding 18%. This could occur if even weaker market and industry conditions in Italy impaired profitability beyond our expectations. Furthermore, we would lower the ratings on Hera if Italy were downgraded by more than one notch, as we assess that it has "high" exposure to Italian country risk.

In our view, rating upside could arise if Hera's financial risk profile strengthens beyond our expectations. We view sustainable adjusted FFO to debt in the 20%-25% range as commensurate with a higher rating for Hera, assuming no further change on the rating on Italy and no change in our assessment of Hera's business risk profile.

Related Criteria And Research

All articles listed below are available on RatingsDirect on the Global Credit Portal, unless otherwise stated.

Related criteria

- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Nonsovereign Ratings That Exceed EMU Sovereign Ratings: Methodology and Assumptions, June 4, 2011
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Principles Of Credit Ratings, Feb. 16, 2011
- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Methodology For Linking Short-Term and Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers

Related research

- Italian Companies Are Turning To The Capital Markets Amid Weak Credit Conditions, June 5, 2013

Ratings List

Downgraded; CreditWatch/Outlook Action; Ratings Affirmed

	To	From
Hera SpA		
Corporate Credit Rating	BBB/Stable/A-2	BBB+/Negative/A-2
Senior Unsecured	BBB	BBB+

Additional Contact:
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.