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Standard & Poor's Research

Research Update:

Italian Multi-Utility Hera 'BBB+/A-2' Ratings Affirmed; Outlook Stable

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Table Of Contents

1017070 | 300642892

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Overview

- We no longer consider Italian utility Hera as a government-related entity under our criteria.
- We consider that the change in GRE status has no effect on the ratngs on Hera.
- We are affirming our 'BBB+/A-2' long- and short-term ratings on Hera.
- The stable outlook reflects our opinion that Hera will succeed in further strengthening its currently below-average credit metrics despite its exposure to Italy's low-growth environment.

Rating Action

On Sept. 28, 2012, Standard & Poor's Ratings Services affirmed its 'BBB+' long-term and 'A-2' short-term corporate credit ratings on Italian multi-utility Hera SpA. The outlook is stable.

Rationale

The affirmation follows our decision to no longer consider Hera as a government-related entity (GRE) under our criteria, which has no effect on Hera's corporate credit ratings. We had previously assumed a low likelihood of support for Hera, if needed, from its Italian joint municipal government shareholders in the event of financial distress.

In our opinion, Hera may not benefit from timely and sufficient exceptional support from its joint municipal shareholders in the future. Our assessment is based on the lack of evidence of exceptional support in the past. For instance, the company's credit metrics have deteriorated following various debt-financed acquisitions. We also foresee increasing dilution of existing individual municipal stakes in Hera after it consolidates Italian multi-utility ACEGAS APS in 2013. In our view, the majority control of Hera's equity capital by municipal governments is a constraint on the dividend policy.

Our assessment of Hera's business risk profile as strong continues to reflect a well-balanced portfolio where low-risk monopoly-regulated operations contribute about 50% of total EBITDA. It also factors in the concentration of operations in Italy's wealthiest regions. The company's dominant local positions in waste, gas supply, and water management also support our assessment. However, we consider that Hera's business risk profile is weakened

1017070 | 300642892

by the company's exposure to increasing country risk in Italy, which in an international comparison translates into greater fiscal pressure and average cost of debt. In addition, Hera's sizeable waste treatment business is cyclical.

We see significant financial risk arising from Hera's below-average and only gradually improving credit metrics in the challenging domestic environment. In our base-case scenario we expect Hera to post adjusted funds from operations (FFO) to adjusted debt at around 20% in 2013 and 2014, versus 16.9% in 2011. In particular, our anticipation that Hera will be able to generate neutral to positive free cash flow after dividends over the next two years supports our belief that it will strengthen its credit ratios. Our base-case scenario factors in the consolidation of ACEGAS APS as of 2013.

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 (capex), debt service, and dividends--with available cash, committed credit lines on June 30, 2012, and our expectation of FFO, by more than 2.0x in the following 12 months.

Our assessment is underpinned by:

- Access to unrestricted cash of more than €507 million, of which 85% is held at the parent company level;
- Available committed credit lines of €420 million on June 30, 2012, with a maturity longer than 12 months; and
- Our forecast that Hera will generate annual adjusted FFO of about €500 million in the next 12 months.

This compares with our forecast that over the next 12 months, Hera faces:

- An average €300 million of capex,
- Dividend outflows of approximately €120 million, and
- Debt maturities below €100 million.

Beyond the 12-month horizon, we assume that Hera will repay in cash its €140 million convertible bond in the second half of 2013 and integrate the potential risk of the exercise of the put option on its bonds for a total €270 million in 2014.

In our base-case scenario, we anticipate that Hera will post neutral to positive discretionary cash flow after capex and dividends over the next two years.

Outlook

The stable outlook reflects our opinion that Hera will succeed in further strengthening its currently below-average credit metrics despite its exposure to Italy's low-growth environment. In our opinion, the acquisition of ACEGAS

APS will be neutral for Hera's prospective credit metrics, prior to consolidation. However, in our view, the purchase will offer Hera the opportunity to reap benefits from less competition in its key strategic businesses and extract cost synergies through the management of an enlarged portfolio.

In our view, ratings stability will depend, all other things being equal, on Hera progressing toward a Standard & Poor's-adjusted FFO-to-debt ratio of around 20%, which we believe will occur in 2013-2014. This is significantly higher than the 16.9% achieved in 2011. To accomplish this, we see no leeway for any deterioration in operational and financial performance, especially taking into account its exposure to economic conditions in Italy. Growth in the area of regulated business, which we currently don't factor into our base-case scenario, would be positive for Hera's business risk profile.

In our opinion, ratings upside is limited owing to the pronounced deterioration in Hera's operating environment and its aggressive dividend policy. Any positive rating action would likely arise from Hera's much improved operating and financial outperformance, which we consider unlikely at this stage, coupled with stable debt, gradually resulting in an FFO-to-debt ratio at about 25% or higher.

We could downgrade Hera if we believe that the company would at best achieve a stabilization of its current below-average credit metrics for its rating category, either depending on a weaker than expected operating performance or increasingly aggressive financial management. The former could also lead us to revise our opinion on the resilience of Hera's business model to the economic environment.

According to our criteria we could also lower the rating on Hera if we lower the sovereign rating on the Republic of Italy (BBB+/Negative/A-2, unsolicited) by two notches or more, owing to Hera's high exposure to country risk in Italy (see "General Criteria: Nonsovereign Ratings That Exceed EMU Sovereign Ratings: Methodology And Assumptions," published June 14, 2011, on RatingsDirect on the Global Credit Portal).

Related Criteria And Research

- 2008 Corporate Criteria: Ratios And Adjustments, April 15, 2008
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008
- Understanding Standard & Poor's Rating Definitions, June 3, 2009
- Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Rating Government-Related Entities: Methodology And Assumptions, Dec. 9, 2010
- Principles Of Credit Ratings, Feb. 16, 2011
- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010

- Methodology: Short-Term/Long-Term Ratings Linkage Criteria For Corporate And Sovereign Issuers, May 15, 2012

Ratings List

Ratings Affirmed

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

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Complete ratings information is available to subscribers of RatingsDirect on the Global Credit Portal at www.globalcreditportal.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.