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Hera SpA

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Table Of Contents

Hera SpA

Major Rating Factors

Corporate Credit Rating
BBB+/Stable/A-2

Strengths:

- Well-balanced portfolio of utility services with a 50% share of low-risk regulated activities.
- Our expectation of positive free cash flow generation, supported by declining capital expenditures over the medium term.
- Prime service area in Italy's prosperous Emilia-Romagna region.
- Dominant local position in waste management and water, as well as a leading position among gas suppliers in Italy.

Weaknesses:

- Exposure to tightening fiscal measures as a consequence of national austerity measures to be implemented in 2011-2013.
- Recent regulatory uncertainty in the Italian water sector, potentially leading to weaker profitability.
- Historically acquisitive growth strategy.
- Aggressive dividend distribution policy.

Rationale

The ratings on Italy-based multi-utility Hera SpA reflect Standard & Poor's Ratings Services' view of the group's strong business profile. It is underpinned by a well-balanced utility portfolio, in which low-risk, monopoly-regulated operations contribute about 50% of the group's EBITDA. The ratings are also supported by our view of Hera's ability to generate positive free cash flow (FCF) over the medium term and to improve geographical diversification, its dominant local position in waste and water management, as well as its leading position as a gas supplier in Italy.

These rating supports are partially offset by Hera's significant financial risk profile, exposure to tightening fiscal measures as part of the national deficit reduction strategy over the next three years, and the unexpected regulatory uncertainty in Italy's water sector. In addition, we consider Hera's opportunistic growth strategy and aggressive dividend policy as a risk to its credit risk profile.

The 'BBB+' rating on Hera is based on the group's stand-alone credit profile (SACP), which we assess at 'bbb+'. Although Hera is classified as a government related entity (GRE), our assessment is that there is a "low" likelihood of extraordinary government support.

Key business and profitability developments

We view positively Hera's results for first-half 2011, which suggest the group is on track to meet its budget objectives in 2011. Reported revenues and EBITDA were up 8% and 9.7%, respectively, year-on-year. This was mainly a result of solid profitable organic growth in liberalized activities (such as Hera's energy segment) and realized cost efficiencies. Moreover, substantial new customer growth supported an increase in Hera's electricity retail earnings, resulting in higher electricity volumes sold. In gas supply, Hera was able to maintain its existing client base. Its gas margins benefited from its flexible procurement strategies as compared with its peers, which offset the effect of negative volume that resulted from adverse weather conditions. The group's waste operations also contributed to positive EBITDA growth, despite lower-than-expected volumes, which the group attributes to a slowdown of industrial production. Hera's regulated gas, water, and electricity distribution segment benefited from positive tariff adjustments, which offset the negative effects of slightly lower volumes and new connections.

Contribution from newly acquired businesses also supported operating earnings in first-half 2011.

Key cash flow and capital-structure developments

Hera expects its net debt to remain below €2 billion in 2011, on the back of a reduction of capital expenditures (capex) as it has completed the bulk of its investment plan in the waste sector. Consequently, we have factored a recovery into Hera's financial profile, resulting from growing cash flow generation and debt stabilization. Hera's statements support this, acknowledging that the group projects a decline in its net debt-to-EBITDA ratio to below 2.8x by 2014 from the reported 3.3x in 2009.

Although we foresee a challenging market environment for the group's liberalized activities, we believe that Hera should be able to take advantage of its short position in energy, its effective procurement strategy, its growing and diversified client base, and its focus on the realization of further cost efficiencies to support profitability in the near to medium term. We project that Hera's adjusted FFO-to-debt ratio will be in the low-range of our 16%-20% rating guidance in 2011, progressively improving after to mid- to high-range in 2014, in line with the rating. A gradual strengthening of key cash flow credit metrics is key to rating stability, considering our expectation of a gradual rebalancing of Hera's operations to higher contributions of liberalized, higher-risk activities (relative to regulated activities).

We expect Hera to continue posting positive free operating cash flows (FOCF) over the medium term, supportive of our ratings, on the back of operating earnings growth combined with a capex reduction. In addition, we believe that Hera's recent efforts to improve billing systems and reduce counterparty risk tolerance could prevent a repeat of the unexpected large swings in working capital that happened in 2009.

We note that as part of the most recently proposed Italian austerity package, a 10.5% special tax--informally known as the "Robin Hood" tax--was introduced on power distribution activities in 2011-2013 (falling to 6.5% over 2014-2015). In our opinion, the special tax will not substantially affect Hera's financial risk profile, as we believe the group maintains enough flexibility to partly offset the negative influence on its cash flows without considerably impairing its ability to strengthen its financial risk profile.

Liquidity

We consider Hera's liquidity to be adequate. On June 30, 2011, the group reported €356 million of cash and cash equivalents, of which €294 million was held at the parent company, €62 million at the subsidiaries, and €280 million available under three undrawn committed credit lines, maturing between July 2012 and July 2014. Debt maturing in the next two years amounts to €82 million.

Hera expects cash flow to be positive before dividend distributions in 2011 and 2012, but that distributions will likely be debt funded. Hera has announced planned investments in 2011-2013 of approximately €900 million. We believe about 58% of these investments are allocated for growth capex, which is partly discretionary and supports the group's financial flexibility.

Some of Hera's outstanding bonds (approximately 25%) contain put options, enabling bond investors to request redemption of the bonds if the group's long-term rating falls below 'BBB-' or if there is a change of control. This could trigger a credit cliff scenario if Hera's credit standing unexpectedly significantly deteriorates, weighing on our assessment of its liquidity.

Hera issued about €400 million of bonds with put options in 2007 and 2008, with the next bond of €200 million exercisable in October 2011. Considering the step-up structure embedded in the bond coupon, we believe there is a low likelihood that the option would be exercised. However, the availability of undrawn committed lines substantially mitigates the group's refinancing risk.

Outlook

The stable outlook reflects our opinion that, over the medium-term, Hera should maintain a financial risk profile commensurate with the 'BBB+' rating category, supported by our expectations of improving operating cash flows and debt stabilization.

In our view, rating stability would depend, all other things being equal, on Hera posting a Standard & Poor's-adjusted FFO-to-debt ratio in the range of 16%-20% over the cycle. We expect the group will be positioned at the low-end of the range in 2011 and, consequently, there will be little headroom for any deterioration in the group's operational and financial performance. We also assume only a marginal dilution of Hera's business risk, resulting from the growing contribution of higher-risk liberalized activities, which now represent about half of EBITDA.

In our opinion, a ratings upside is limited owing to Hera's relatively weak credit metrics, which are expected to only gradually improve. Any ratings upside would likely arise from any unexpected operating and financial outperformance coupled with stable debt, eventually resulting in a stabilizing FFO-to-debt ratio at around 20% or above. In addition, a major rebalancing of its activities to more low-risk regulated operations could support a higher rating.

Business Description

Hera is one of Italy's largest regional multi-utilities and serves about 70% of the Emilia-Romagna region.

The group's diversified business portfolio encompasses the sale and distribution of gas and electricity, the provision of integrated water services, urban and special waste collection and disposal services, and ancillary activities, such as district heating and public lighting. The share of earnings by business unit remained roughly stable in 2010 compared with in 2008. Low-risk regulated activities contributed about 50% of EBITDA in 2010, and we believe that this proportion could decline slightly further by 2014.

Hera was formed in 2002 through the integration of 11 public service companies in Emilia-Romagna. Since 2003, the company has been listed on the Italian stock exchange and about 61% (51% of which is bound by a shareholder agreement) is held by 190 public institutions (municipalities, provinces, or consortia), 7.5% is retained by bank foundations, and the remainder is free float.

Government Support And GRE Methodology Impact

We assess Hera's SACP at 'bbb+'. We believe that there is a "low" likelihood of extraordinary government support, based on our assessment of Hera's:

- "Limited" role for municipal shareholders. Although Hera is a dominant provider of public utility services, and therefore is strategically important for the municipal shareholders, its activities could, in our opinion, be undertaken by another private or public sector entity if Hera ceased to exist.
- "Limited" link with its municipal shareholders, given its fragmented ownership. We believe a timely agreement on providing potential support to Hera is complicated by its fragmented shareholder structure and governance model. The municipal ownership is split between 190 local municipalities owning 61.3% of the capital.

Business Risk Profile: Strong, Underpinned By Stable And Predictable Regulated Activities, A Growing Customer Base, And Moderate Operating Risk

The major supports of Hera's strong business risk are:

- A relatively diversified portfolio of utility businesses in one of Italy's richest regions, which helps counterbalance various seasonal features and supports customer retention through a multi-offer approach.
- The contribution from stable and regulated businesses (water, waste collection, electricity, and gas distribution), which are operated under long-term concessions and are remunerated based on tariff frameworks intended to cover operating and capital costs. These activities generated about 50% of Hera's EBITDA in 2010. However, the relative EBITDA contribution from unregulated businesses is expected to increase by 2013. In addition, the current regulatory periods are due to be reviewed in 2012-2013, which increases regulatory reset risk. We currently do not foresee any significant negative revisions to the framework, but we acknowledge that fiscal pressure in Italy has increased. Long-term concessions offer ratings support. The concession for water is valid until 2024 and for electricity distribution until 2030, whereas for waste and, in particular, gas distribution, the concessions are of shorter duration. Gas distribution is due to be retendered in 2013, implying higher renewal risk. However, the tendering of gas concessions is contingent on the implementation of a dedicated legislated regulatory framework, which has been pending for several years.
- The group's dominant local market position and fairly supportive customer service area. Hera is the leading local operator in all of its divisions, except in electricity retail. It has a regional market share of about 87% in water and 77% in waste collection. In energy services, Hera benefits from its status as the incumbent supplier, serving over 70% of customer demand, and has been exposed to only limited competition in the past. In addition, we view Hera's annual customer retention rate as supportive to long-term profitability. In the past five years, Hera has achieved almost complete coverage of the reference area (Emilia-Romagna) in the gas sector and it is currently the fourth largest on a national level, in terms of volume distributed.

These strengths are slightly offset by:

- A highly acquisitive strategy, although Hera has acquired companies partly through mergers and share swaps. Despite Hera's good track record in integration and historically positive contribution to cash flows, its acquisitive nature could, in our opinion, lead to a delay in our anticipated recovery of the group's financial risk profile or dilute the group's business risk profile.

- High reliance on its waste division as a main source of growth. Hera forecasts that about 40% of EBITDA growth until 2014 will be generated by organic growth in waste. We believe this could prove challenging, as waste volumes treated are sensitive to economic conditions.
- The growing liberalization of Italy's utility markets. As competition increases for Hera's electricity generation and sales unit, sales margins on eligible customers could decline. However, total electricity customers have increased to 435,000 in 2010, from 335,300 in 2009, because of Hera's ongoing expansion in the free market and the gradual migration of customers into that market. Nevertheless, we also believe Hera may face increased competition in gas supply where the group is a local incumbent, which might lead to margin erosion.
- Operating risks from the expansion of the group's waste-to-energy (WTE) activities. The regulator grants the highest tariff for WTE plants that use selected recyclable waste. In our view, the main risk centers on the operation of the plants and the availability of recyclable waste to process. However, the plants' close location to urban areas, coupled with a structural lack of available treatment capacity in Italy, partially alleviates these risks.
- Exposure to climate, regulatory, and supply risk in the gas division. Mild winters can significantly affect the volume of supplied gas and its profitability. The group remains dependent on the incumbent, Eni SpA (A+/Stable/A-1). This dependence is lower than in the past, however, owing to increased recourse to alternative long and spot contracts, and we believe it should decline further in the medium term once the Galsi pipeline comes onstream.

Financial Risk Profile: Significant, Improved Liquidity And An Expected Recovery In Credit Metrics

The main weaknesses of Hera's significant financial risk are:

- An aggressive financial policy. In the past years, the dividend policy has seen payout ratios exceeding 80%. Management expects the group to maintain a high payout ratio, aiming to increase dividends year-on-year.
- Weak average credit metrics for the ratings, with the adjusted FFO-to-debt ratio falling to a range of 12%-15% in 2009-2010 as a result of rising debt. Total adjusted-debt rose to €2.1 billion at year-end 2010, up from €1.5 billion in 2006, reflecting Hera's highly negative FOCF over 2006-2009.
- Ambitious EBITDA growth targets (€750 million in 2014 as compared with €607 million in 2010). We believe that the group's targets are motivated by expectations of a very strong performance in the waste sector. We believe this growth could be challenged by the weak economic conditions in Italy to which the waste sector is exposed.

These weaknesses are partially mitigated by:

- A high degree of cash flow predictability. Regulated utility businesses generate more than one-half of cash flow. Revenue growth from unregulated businesses is anticipated, following the completion of the past three years' capex plans.
- Our expectations of positive FCF from 2010. We think the group should continue to have positive FOCF in 2011 and 2012. Over that period, we project decreasing capex, rising cash flow generation, and improved management of working capital as key factors of FOCF recovery.
- Our anticipation of a stable debt position. Based on our projections, we anticipate that debt accrual will plateau owing to increasingly positive FOCF from 2011 onward. Hera expects to slightly increase its debt but decrease its net debt-to-EBITDA ratio to less than 3.0x from 3.3x in 2009. We think this improvement could be supported by

stronger cash flow generation from waste and a slight decrease in capex to an average €330 million over 2012-2014 from an average €410 million in 2007-2010.

- Prudent debt management, with a fairly spread out maturity profile (average maturity of 10 years), no currency risk, no material contingency requirements, and nearly 70% of debt at fixed rates.

Financial Statistics/Adjustments

Hera reports according to international financial reporting standards (IFRS) and in line with international accounting standards.

We make adjustments to Hera's reported accounts for the power purchase agreement as follows:

- We no longer adjust for the commitment with ATEL (not rated), as the exit clause was triggered in 2010 and the long-term contract will be terminated after the payment of €2 million per year in 2010 and 2011.
- We add €68.1 million to debt, as it is the present value (based on the 5.0% cost of debt) of Hera's commitment to finance a nonrecourse project financing at the Sparanise plant. Hera is committed to €7.6 million per year in the coming 12 years and €1.3 million in the following year.

We also make further adjustments to Hera's reported accounts:

- We add €49 million to 2010 debt, related to financial guarantees granted in relation to SET (not rated, an associated company that Hera has not consolidated). We also add €65.7 million related to an asset retirement provision for landfill closure and post-closure costs, €90.2 million of employee-related benefits, and €51.1 million of operating leases.
- At the same time, we deduct €55.9 million from debt to account for nonrecourse debt for secured project finance loans that were obtained by the subsidiary FEA Srl (not rated), as well as €538 million of cash. The cash adjustment acknowledges the recurring presence of significant cash balances on the group accounts.

Table 1

Reconciliation Of Hera SpA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)

	--Fiscal year ended Dec. 31, 2010--									
Hera SpA reported amounts										
	Debt	**Shareholders' equity**	**Revenues**	**EBITDA**	**Operating income**	**Interest expense**	**Cash flow from operations**	**Cash flow from operations**	**Dividends paid**	**Capital expenditures**
Reported	2,475.0	1,727.5	3,803.7	539.6	315.4	111.8	355.8	355.8	96.8	323.8
Standard & Poor's adjustments										
Operating leases	51.1	--	--	2.6	2.6	2.6	9.5	9.5	--	6.5
Postretirement benefit obligations	90.2	--	--	--	--	1.4	3.9	3.9	--	--
Surplus cash and near cash investments	(538.2)	--	--	--	--	--	--	--	--	--
Capitalized interest	--	--	--	--	--	4.4	(4.4)	(4.4)	--	(4.4)

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Table 1

Reconciliation Of Hera SpA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €) (cont.)										
Nonrecourse debt	(55.9)	--	--	--	--	--	--	--	--	--
Power purchase agreements	68.1	--	--	7.6	3.4	3.4	4.2	4.2	--	4.2
Asset retirement obligations	65.7	--	--	--	--	7.1	(5.8)	(5.8)	--	--
Reclassification of nonoperating income (expenses)	--	--	--	--	11.2	--	--	--	--	--
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	(30.4)	--	--
Minority interests	--	142.7	--	--	--	--	--	--	--	--
Debt - Guarantees	49.3	--	--	--	--	--	--	--	--	--
Debt - Derivatives	4.0	--	--	--	--	--	--	--	--	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	--	--	(6.1)	(6.1)	--	--	--	--	--
EBITDA - Other	--	--	--	2.0	2.0	--	--	--	--	--
Total adjustments	(265.7)	142.7	0.0	6.1	13.1	19.0	7.5	(23.0)	0.0	6.3
Standard & Poor's adjusted amounts										
	Debt	**Equity**	**Revenues**	**EBITDA**	**EBIT**	**Interest expense**	**Cash flow from operations**	**Funds from operations**	**Dividends paid**	**Capital expenditures**
Adjusted	2,209.3	1,870.2	3,803.7	545.8	328.5	130.8	363.3	332.9	96.8	330.0

Table 2

Hera SpA Financial Summary					
	--Fiscal year ended Dec. 31--				
	2010	**2009**	**2008**	**2007**	**2006**
Rating history	BBB+/Stable/A-2	A-/Negative/A-2	A/Negative/A-1	A/Stable/A-1	A/Stable/A-1
(Mil. €)					
Revenues	3,803.7	4,356.1	3,716.3	2,863.3	2,311.5
EBITDA	545.8	501.8	487.6	403.8	404.0
Operating income	317.3	273.5	287.2	227.6	238.2
Net income from continuing operations	117.2	86.4	94.8	96.2	90.1
Funds from operations (FFO)	332.9	289.5	292.6	287.8	327.1
Capex	330.0	387.7	437.2	498.7	399.7
Free operating cash flow	33.3	(153.7)	1.3	(162.8)	12.0
Dividends paid	96.8	94.5	92.9	89.7	76.8

Table 2

Hera SpA Financial Summary (cont.)					
Discretionary cash flow	(63.5)	(248.2)	(91.6)	(252.5)	(64.8)
Debt	2,209.3	2,173.9	1,897.2	1,724.3	1,501.3
Preferred stock	0.0	0.0	0.0	0.0	0.0
Equity	1,870.2	1,700.7	1,579.1	1,538.6	1,516.3
Debt and equity	4,079.6	3,874.6	3,476.3	3,262.9	3,017.6
Adjusted ratios					
EBITDA margin (%)	14.3	11.5	13.1	14.1	17.5
EBITDA interest coverage (x)	4.2	4.3	4.0	4.4	6.1
EBIT interest coverage (x)	2.5	2.4	2.5	2.6	3.9
FFO interest coverage (x)	3.3	3.5	3.3	4.0	5.7
FFO/debt (%)	15.1	13.3	15.4	16.7	21.8
Free operating cash flow/debt (%)	1.5	(7.1)	0.1	(9.4)	0.8
Discretionary cash flow/debt (%)	(2.9)	(11.4)	(4.8)	(14.6)	(4.3)
Net cash flow/capex (%)	71.5	50.3	45.7	39.7	62.6
Debt/EBITDA (x)	4.0	4.3	3.9	4.3	3.7
Debt/debt and equity (%)	54.2	56.1	54.6	52.8	49.8
Return on capital (%)	8.0	7.4	8.7	7.3	8.5
Return on common equity (%)	6.7	4.8	5.5	6.0	6.0
Common dividend payout ratio (un-adjusted) (%)	85.6	103.3	87.2	84.5	90.2

Capex--capital expenditures.

Table 3

Hera SpA Peer Comparison					
	Hera SpA	**Acea SpA**	**A2A SpA**	**Verbund AG**	**Veolia Environnement S.A.**
Rating as of Sep. 30, 2011	BBB+/Stable/A-2	A/Negative/A-1	BBB+/Negative/A-2	A-/Stable/(A-2)	BBB+/Stable/A-2
	--Average of past three fiscal years--				
(Mil. €)					
Revenues	3,958.7	2,679.1	6,080.3	3,511.9	34,834.4
EBITDA	511.7	572.8	1,061.5	1,237.1	3,858.0
Operating income	292.7	368.3	627.8	1,029.4	2,006.3
Net income from continuing operations	99.4	420.9	154.3	577.3	493.9
Funds from operations (FFO)	305.0	415.9	773.0	995.2	3,377.2
Working capital	40.3	(119.6)	(32.7)	(78.6)	144.7
Cash flow from operations	345.3	296.3	740.4	916.6	3,522.0
Capital expenditures	385.0	458.6	411.0	529.8	3,049.3
Free operating cash flow	(39.7)	(162.3)	329.4	386.8	472.7
Discretionary cash flow	(134.4)	(254.8)	42.4	(36.0)	(168.6)
Cash and short-term investments	0.0	0.0	81.3	46.4	654.0
Debt	2,074.8	2,472.5	5,120.3	3,887.5	19,606.7
Equity	1,716.7	1,370.8	4,720.7	3,888.3	10,132.6
Adjusted ratios					
EBITDA margin (%)	12.9	21.4	17.5	35.2	11.1

Table 3

Hera SpA Peer Comparison (cont.)					
EBITDA interest coverage (x)	4.2	5.9	5.9	5.1	3.3
EBIT interest coverage (x)	2.5	4.0	3.5	4.7	1.8
Return on capital (%)	8.1	10.1	6.5	15.8	6.9
FFO/debt (%)	14.7	16.8	15.1	25.6	17.2
Cash flow from operations/debt (%)	16.6	12.0	14.5	23.6	18.0
Free operating cash flow/debt (%)	(1.9)	(6.6)	6.4	9.9	2.4
Discretionary cash flow/debt (%)	(6.5)	(10.3)	0.8	(0.9)	(0.9)
Discretionary cash flow/EBITDA (%)	(26.3)	(44.5)	4.0	(2.9)	(4.4)
Debt/EBITDA (x)	4.1	4.3	4.8	3.1	5.1
Total debt/debt plus equity (%)	54.7	64.3	52.0	50.0	65.9

Related Criteria And Research

- Methodology And Assumptions: Standard & Poor's Standardizes Liquidity Descriptors For Global Corporate Issuers, July 2, 2010
- Italian Utility Hera SpA Downgraded To 'BBB+' On Weakened Financial Profile; 'A-2' Rating Affirmed; Outlook Stable, June 23, 2010
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009
- Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Italian Utilities A2A, Acea, Hera, And AQP Not Immediately Affected By The Outcome Of Two Water Referendums, June 14, 2011

Ratings Detail (As Of September 30, 2011)*	
Hera SpA	
Corporate Credit Rating	BBB+/Stable/A-2
Senior Unsecured (7 Issues)	BBB+
Corporate Credit Ratings History	
23-Jun-2010	BBB+/Stable/A-2
17-Apr-2009	A-/Negative/A-2
17-Jun-2008	A/Negative/A-1
21-Dec-2006	A/Stable/A-1
Business Risk Profile	Strong
Financial Risk Profile	Significant
Debt Maturities	
As of Dec. 31, 2010: 2011: €109 mil. 2012: €34 mil. 2013: €172 mil. 2014: €27 mil. 2015: €200 mil After: €1.850 bil.	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

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