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Research Update:

Italian Utility Hera SpA Downgraded To 'A-/A-2' On Weakened Financial Profile; Outlook Negative

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Rationale

On April 17, 2009, Standard & Poor's Ratings Services lowered its long- and short-term corporate credit ratings on Italian utility Hera SpA (Hera) to 'A-/A-2' from 'A/A-1'. The outlook is negative.

The rating action reflects our view that Hera's financial profile is no longer commensurate with an 'A' rating given the company's recent performance and the current industry environment.

The ratings reflect Hera's relatively strong business profile, underpinned by a well-balanced portfolio to which low-risk monopoly-regulated operations contribute about 60% of EBITDA. The ratings also take into account Hera's strong franchise in the wealthy and populated northern Italian Region of Emilia-Romagna (A+/Stable/--). These positive factors are offset, however, by Hera's increasing involvement in the riskier electricity generation and trading business, a weakened financial profile, and a very aggressive dividend policy.

Hera is Italy's largest regional utility and serves about 70% of Emilia-Romagna's territory. The company's portfolio mix is balanced, with 35% of EBITDA stemming from waste, 26% from water, 23% from gas, 9% from electricity, and 7% from other businesses in 2008.

Hera reported 16.5% EBITDA growth to €528 million in 2008, falling somewhat short of expectations. Weather conditions, electricity distribution tariff reductions, and project delays partially hindered this positive performance. Net reported debt also came in somewhat higher than expected, at close to €1.6 billion, mainly on the back of higher capital expenditures. In its updated 2009-2011 business plan, Hera anticipates ongoing growth in operating performance thanks to further efficiency improvements and the cash flow contribution of assets under construction, leading in turn to an EBITDA increase to €670 million in 2011. However, the company expects net debt to increase slightly in 2009 and then remain fairly flat on the back of declining capital expenditures as Hera completes its investment plan. Hera consequently anticipates that its financial profile should recover in the coming years We believe, however, that the extent and speed of this recovery may be lower than what Hera forecasts, given the current sluggish market conditions and the company's ambitious growth targets.

Liquidity

We consider Hera's liquidity as adequate. As of Dec. 31, 2008, the company reported €194 million of cash and had €350 million available under three-year committed credit lines that it has since increased to €530 million. Maturing debt amounts to €209 million in 2009 and to €54 million in 2010.

Hera expects to be slightly cash flow negative in 2009 and then broadly cash neutral. Planned investments in 2009-2011 total approximately €1.1 billion, of which 40% is for development capital expenditures, entailing a degree of flexibility. The company recently indicated that it has already started to reduce capital expenditures by 25% in the first two months of 2009.

There are no financial covenants in the company's financing agreements. Other covenants are manageable.

Hera's €1 billion bonds contain a put option enabling bond investors to sell back the bonds to Hera if the long-term corporate credit rating falls below 'BBB-' following a change of control.

Of the bonds with put options, the company issued €500 million in 2007-2008, with the first put exercisable in May 2010 on €100 million. Hera also has loans totaling €100 million, carrying put options exercisable from November 2010. The company intends to keep undrawn committed lines to fully cover the amounts that it could potentially have to prepay well ahead of the put exercise dates in order to mitigate refinancing risk.

Outlook

The negative outlook is based on our view that, in light of Hera's recent performance, the company has limited financial flexibility in the coming years within the current ratings, at a time when its earnings and cash flow could come under strain.

We could lower the ratings if Hera's financial profile remains weak in 2009 and we deem a sufficient recovery unlikely in 2010. Taken together, these factors could prevent the company from achieving coverage of funds from operations (FFO) to debt of about 20% by 2010 on a sustainable basis. We will also consider how the group manages its investment plan amid the current economic backdrop. The ratings do not factor in material changes in business risk, mergers or acquisitions, or changes in financial and dividend policies.

Conversely, we could revise the outlook to stable if we see sufficient signs of Hera's ability to achieve a credit profile adequate for the current ratings in the next two years. This would likely entail ongoing robust growth in the company's operating performance and tight debt control.

Ratings List

Downgraded

	To	From
Hera SpA		
Corporate Credit Rating	A-/Negative/A-2	A/Negative/A-1
Senior Unsecured	A-	A

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