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Research Update:

Italian Multi-Utility Hera 'BBB/A-2' Ratings Affirmed On Stabilized Financial Performance; Outlook Stable

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Overview

- We have revised our base case on Italian multi-utility Hera, and now expect funds from operations (FFO) to debt above 20% for the period 2016-2018 versus 18% previously.
- Hera's financial performance in 2016 was more resilient to a series of domestic risks than we expected, including a relatively severe regulatory reset of its regulated power and gas activities, coupled with a low-growth environment.
- We are therefore affirming our 'BBB/A-2' ratings on Hera.
- The stable outlook reflects our expectation that Hera will potentially report adjusted FFO above 20% over the next 24 months.

Rating Action

On March 31, 2017, S&P Global Ratings 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 reflects our view that Hera's financial performance has stabilized. We have revised our base-case scenario for Hera and now expect FFO to debt exceeding 20% over the next two years, up from 18% previously.

Over the last five years Hera's mergers and acquisition (M&A) strategy allowed the group to extend the scale and scope of its operations in virtually all its business lines, albeit less so in power distribution. It also enabled the company to extend its geographic reach beyond its initial regional dimension, resulting in higher resilience to the low-growth environment it faces in Italy, as well as to the unprecedented, negative regulatory reset in 2016. We believe that the external growth achieved via credit friendly acquisitions, balance growth of regulated (water, gas, and power distribution) and unregulated activities (integrated waste treatment service and gas and power supply), and a balanced approach to equity and debt stakeholders pave the way for a more solid financial performance in the future. We now expect Hera will sustain adjusted FFO to debt structurally above 20%.

Our revised view on Hera's future developments integrates the following elements:

- Here's ability to extend its debt maturity profile and decrease the weighted average cost of debt to 3.7% in 2016 thanks to liability management in October 2016, which pushed Hera's first material refinancing needs to 2019.
- The recent announcement of the Aliplast acquisition in the waste segment, which we view as supportive in terms of debt to EBITDA and supporting Hera's national leadership in the waste business.
- Hera's proven positive track record in improving cash collection, leading to a leaner working capital management.
- Hera's ability to more than offset the €24.5 million regulatory weighted-average cost of capital cuts.
- Credit friendly acquisitions to continue into 2017.

The resilience of Hera's performance is linked to its solid business mix, namely that of its diversified portfolio of regulated and unregulated utility businesses in one of Italy's wealthiest northeastern regions. The company operates stable and regulated businesses--water, electricity, and gas distribution--under long-term concessions that are remunerated based on tariffs established by the national regulatory authority, l'Autorità per l'energia elettrica il gas e il sistema idrico (AEEGSI).

We expect acquisitions will continue to drive Hera's growth in the current low-growth economic environment we anticipate in Italy over the next few years. Hera's acquisitive strategy is not detrimental to the rating as long as the group continues to finance sizable transactions through share swaps. We note that Aliplast is the only acquisition that will be on a cash basis, but we also note that the impact on Hera is marginal in terms of size as we expect it to contribute about €15 million-€16 million to the group's EBITDA. Hera's proven skills in integrating new businesses and extracting cost synergies is supportive of the business risk profile and enables the company to mitigate the impact of volatile market conditions and adverse regulatory decisions. The group's strengths are partly offset by its almost exclusive exposure to Italian country risk.

The gradually improving financial risk profile is evidenced by our view of a step change in Hera's adjusted FFO to debt, which we see now consolidating at around 20%, up from 18% previously. Over the next 12-24 months, we continue to see FFO to debt above 20%. We believe, though, that a clear trajectory toward 23%, our trigger for an upgrade, is contingent upon Hera's pursuing credit friendly, EBITDA-accretive acquisitions In Italy's low growth environment, as well as no lowering of our unsolicited 'BBB-' ratings on Italy.

We believe there is a reasonable likelihood that Hera would be able to withstand a sovereign default. We have stress-tested Hera's business risk and financial risk profiles in a hypothetical default scenario for Italy. We think that Hera's ability to service and repay debt is superior to that of the Italian government. Consequently, we rate Hera one notch above our 'BBB-' sovereign rating on Italy.

In our base-case scenario, we forecast that, over the next three years, Hera will continue posting almost neutral cash flow after capital expenditures (capex) and dividends before acquisitions. Despite the unfavorable economic environment, Hera's prudent debt management, good bond-market access, strong liquidity, and good degree of cash flow predictability (determined by the high and potentially increasing share of regulated business in Hera's portfolio), together with hefty M&A activity development, underpins our belief that the company is gaining headroom under the currently assigned rating category.

In our base case, we assume:
- Increased revenues by 4% compound annual growth rate (CAGR) for Hera's business plan, Horizon 2016-2020.
- EBITDA improving by 4.2% CAGR thanks to the business plan Horizon.
- Weighted average cost of debt of 3.7% for 2017 and 3.6% for 2018.
- Negative changes in working capital for 2017 and 2018 of about €20 million on an annual basis.
- Capex of €500 million in 2017 and €650 million in 2018.
- A potential cash dividend increase to €160 million, owing to a dilution effect of share swaps in Hera's M&A activity. Any changes in the dividend policy would put negative pressure on ratings.
- Net debt on unadjusted basis of €2.8 billion-€3.1 billion for 2017-2018.

Based on these assumptions, we arrive at the following credit measures:
- Debt to EBITDA for 2017-2018 at around 3.5x.
- FFO to debt for 2017-2018 above 20%.
- Neutral to slightly positive cash flow from operations after capex and dividends.

Liquidity

Our short-term rating on Hera is 'A-2'. Hera's strong liquidity reflects our view that its planned cash outlays--mainly capex, debt service, and dividends--will be covered by available cash and committed credit lines by more than 1.5x over the 12 months started Jan. 1, 2017, and will remain above 1.0x over the following 12 months.

Principal liquidity sources as of Jan. 1, 2017, include:
- Our estimation of unrestricted cash of more than €350 million;
- Available undrawn committed credit lines of €295 million with maturities exceeding 12 months (this doesn't include the €200 million committed line, which we understand Hera has nearly refinanced with an extended maturity);
- Our forecast that Hera will generate cash FFO of more than €680 million in the next 12 months and €730 million in the subsequent 12 months; and
- New financing of €70 million for Aliplast, neutralized by the same cash out for the acquisition over the next 24 months.

Principal liquidity uses as of the same date:
- Capex of €500 million;
- Dividend outflows of approximately €160 million; and
- Debt maturities exceeding €140 million over the next 12 months.

Hera enjoys high standing in the credit markets. It was among the first European utilities to issue a 10-year green bond at competitive fixed costs of 2%. Hera's relationships with banks, including with the European Investment Bank, are sound.

Outlook

The stable outlook reflects our expectation that Hera will potentially report adjusted FFO above 20% over the next 24 months. Positive rating pressure might build if we considered Hera able to achieve FFO to debt of 23% in the coming few years. The outlook also reflects our view that the Republic of Italy (unsolicited; BBB-/Stable/A-3) does not fully constrain Hera's creditworthiness at the current rating level because we consider Hera's liquidity resilient to a hypothetical sovereign default scenario.

Downside scenario

We could lower our ratings on Hera if we considered that it was struggling to achieve and maintain adjusted FFO to debt of about 18% over the next 24 months, which we consider unlikely. This could occur if Italy's market and industry conditions deteriorated, jeopardizing Hera's commitment to maintaining at least neutral cash flow generation after capex and dividends. We would also lower our ratings on Hera if we lowered our sovereign ratings on Italy by more than one notch, given that the company's exposure to country risk in Italy is high.

Upside scenario

We could revise the outlook to positive if we considered that Hera would be able to achieve FFO to debt of 23% in the coming 12-24 months. We could raise the ratings in the next 24 months if we observed over this time a clear trajectory of our adjusted FFO to debt for Hera toward 23%, which we believe could be achieved, given the low-growth environment for the issuer, via credit friendly, cash flow accretive acquisitions. However, this scenario is contingent upon there being no change in our rating on Italy or in our assessment of Hera's business risk. A two-notch differential from the unsolicited 'BBB-' rating on Italy would constrain our rating on Hera at a maximum of 'BBB+'.

Ratings Score Snapshot

Corporate Credit Rating: BBB/Stable/A-2

Business risk: Strong
- Country risk: Moderately high
- Industry risk: Low
- Competitive position: Strong

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Stand-alone credit profile: bbb
- Group credit profile: bbb
- Related government rating: BBB-

Related Criteria

- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Environmental Services Industry, Feb. 12, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 01, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

Ratings Affirmed

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

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