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RESEARCH

Hera SpA

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Major Rating Factors

Corporate Credit Rating

A/Stable/A-1

Strengths:
- Well-balanced portfolio of utility services
- Significant share of low-risk, regulated activities
- Service area located in the prosperous Region of Emilia-Romagna
- Business model that supports implementation of operating synergies

Weaknesses:
- Exposure to growing competition in gas and power supply
- Risk of debt-funded external growth
- Risk that fragmentation in the shareholder structure may negatively affect the definition and implementation of strategy

Rationale

The ratings reflect Hera SpA's relatively strong business profile, which is underpinned by a well-balanced portfolio to which low-risk, monopoly regulated operations contribute significantly. The ratings also take intc account Hera's strong franchise in the wealthy northern Italian Region of Emilia-Romagna (A+/Stable/--) an the potential for synergies from the group's business model.

These positive factors are offset, however, by the risks posed by a weakened financial profile after the merger with neighboring utility Meta SpA; potential credit-dilutive external growth; reliance on third-party energy supplies; and mounting competition in the power generation/supply and gas businesses.

Hera is Italy's largest regional utility and serves about 70% of Emilia-Romagna's territory. The company's portfolio of utility services is characterized by seasonality features that counterbalance each other and a significant contribution from low-risk, regulated activities (accounting for an estimated 55% of EBITDA in th first half of 2006). Hera's business portfolio remains well diversified following the merger with Meta. The EBITDA mix at Sept. 30, 2006, was split among waste management, 37%; water, 26%; gas, 25%; electricit 6%; and other utility services, 6%.

Over the first nine months of 2006, Hera successfully integrated Meta, reporting 36% EBITDA growth year on year to €290 million, of which 22 percentage points were attributable to the enlarged consolidation scop (primarily due to Meta) and 14 to organic growth. The contribution of the various business lines to EBITDA growth was quite balanced. Net financial debt stood at about €1.2 billion at Sept. 30, 2006.

Liquidity

Liquidity is adequate, with about €140 million in cash at Sept. 30, 2006, and €250 million in unused three-year committed credit lines, compared with about €292 million in short-term debt. Also, the group has obtained more than €1 billion in uncommitted credit lines, which were unused at Sept. 30, 2006. Thanks to the February 2006 €500 million bond issue maturing in 2016, the average maturity of debt has increased substantially. There are no financial covenants in the company's financing agreements and other covenant are easily manageable.

Outlook

The stable outlook reflects our expectation that Hera should be able to deliver results consistent with its business plan objectives. At the current rating level, Standard & Poor's Ratings Services expects Hera's funds from operations (FFO) to adjusted debt to be about 20% in the short term, and to progress to about 25% in a couple of years, barring material debt-financed M&A activity, which cannot, however, be ruled out

The ratings could come under pressure in the event of material credit-dilutive acquisitions, increasing involvement in higher risk operations, a leveraging-up of the capital structure, or a marked deterioration in the operating environment. Rating upside is limited over the medium term.

A potential merger with neighboring utility Enia SpA is not factored into the current ratings, and both companies recently announced that the project has been abandoned.

Business Description

Hera is Italy's largest regional utility and operates in the northern region of Emilia-Romagna, one of the richest in the country, serving about 70% of the territory. Its business portfolio is well diversified, with more than 50% of EBITDA deriving from regulated activities. At Sept. 30, 2006, waste management accounted fc 37% of EBITDA, water for 26%, gas for 25%, and electricity and other services for 6% each. The significan presence of low-risk activities and the limited exposure to seasonality are considered positive factors for the ratings.

We do not factor any shareholder support into the ratings. About 40% of Hera's capital is traded on the Italian stock market, while the remainder is held by more than 170 local municipalities which are part of a shareholder agreement and are bound by Hera's bylaws to maintain a 51% combined stake. The main shareholder is the City of Bologna (A+/Stable/NR), with a 15% stake, followed by HSST-Modena, with 13.7%. The other shareholders own less than 5.5% each. The lack of a controlling shareholder could pose risk in the event of differing strategic views among the shareholders, but the positive track record in this respect and management's intention to pursue only friendly acquisitions partially offset this risk.

Business Risk Profile

Strategy

Hera's strategy is focused on internal growth through cost savings; development investments, particularly t facilitate upstream integration with power generation and gas supply; and leveraging the customer base through product cross-selling.

Since its inception in 2002, Hera has also been a proactive player in the consolidation of local utilities in Ital through various M&A transactions, the biggest to date being the merger with Meta in 2005. Further externa growth through consolidation is likely in the future: Hera is evaluating both small and sizable opportunities. The actual implementation and timing of these transactions is uncertain however, being dependant on the political agreement among the local governments controlling the companies.

Despite their positive impact on revenue growth and profitability, and Hera's good track record in terms of integration capabilities, these acquisitions would likely pose financial risks through a possible increase in leverage.

Regulation

According to Italian legislation, waste collection tariffs must cover operating and capital costs. The transitior from the collection of charges through taxation by local authorities--which, in the past, directly provided the waste collection service--to a system based on fully cost-reflective tariffs has not yet occurred completely; however, Hera expects gradual tariff increases to make this feasible by 2009. Annual tariffs for the 2005-2007 period have already been agreed upon with local authorities and will result in a 2.5% annual increase for Hera. Waste treatment, which is the high-margin part of the business, is unregulated. Both activities are carried out through long-term service contracts with municipalities and industrial customers. Hera's concessions to operate in six provinces of the Emilia-Romagna region expire in 2012.

In Italy, gas supply has been fully liberalized since 2003, but competition is still constrained by the dominance of Eni SpA (AA/Stable/A-1+), whose market share was 53% in 2005, and the difficulties in reaching small customers in the absence of a distribution network. In addition, gas scarcity, difficulties developing new infrastructure because of strong local opposition, and attempts by the energy authority to s regulated prices in order to protect small customers from price hikes expose gas suppliers to increasing operating risk. Gas distribution, on the other hand, is regulated and run under concessions expiring in 2010 after which the concessions are expected to be tendered by the municipalities. It is unclear, however, how these tenders will be carried out--a matter the central government is expected to address through new legislation. Network tariffs are set every four years by the energy authority through a price cap mechanism. 7.5% allowed return on capital and a 4.6% efficiency factor (on average)--applied to operating costs and depreciation--have been granted for 2005-2008.

The situation in the water sector is somewhat similar to that in waste management, with sector legislation aimed at full liberalization but applied only to a limited extent. In the areas where the water law is applied, tariffs are set through a price cap methodology, entailing a favorable 7.0% return on capital and undemanding 0.5%-1.0% efficiency factors. Hera's tariffs are gradually increasing, in accordance with the law, with an average annual tariff increase of 3.5% having been granted to Hera for the 2005-2007 period; full remuneration of capital has been delayed by a couple of years to 2009-2010, due to increased capital expenditures. The average maturity of Hera's concessions is 15 years, in line with sector levels.

Markets

Overall, we consider Hera's customer base to be a credit strength. In the water sector, residential customer account for two-thirds of volumes. In the waste segment, the possibility for industrial customers--which account for half of volumes but most of cash flow—to switch supplier is limited by Hera's strong position as the leading company in Italy in this business, industry undercapacity, contract length, and the economic disincentive to transport waste more than a certain distance. In the gas and electricity sectors, more than 50% and 85% of volumes, respectively, are represented by nonresidential customers, which are less loyal than households owing to their high price sensitivity and exposure to general macroeconomic conditions. The impact of this risk is mitigated by the generally small size of the nonresidential sector--which often still chooses not to migrate to the eligible market--and the dual-energy offerings being developed by Hera, whic should reduce customer churn risk. To date, Hera's customer retention rate has been good on an annual basis, with gas and electricity churn at less than 1% and negligible, respectively.

Operations

Hera's operational risk is moderate. The company's planned investments of about €1.4 billion for the 2006-2009 period--almost equally split between maintenance and development--seem manageable and could be financed through internal cash flow generation.

Table 1

Hera SpA Operating Statistics

	--Year ended Dec. 31--			
	2005	**2004**	**2003**	**2002**
Gas sales (mcm)	2,786	2,052	1,634	1,444
Water sales (mcm)	228	206	180	176
Power sales (GWh)	3,755	2,282	1,628	948
Waste collection (t, 000s)	1,597	1,260	1,108	1,171
Waste treatment (t, 000s)	3,775	2,676	2,393	2,490

mcm--Million cubic meters. GWh--Gigawatt-hours. t--Tons.

Waste management. Waste management is Hera's most relevant business line, both in terms of revenue growth and operating margin. In the first nine months of 2006, Hera treated about 2.6 million metric tons of waste, almost evenly split between urban and special waste. The company also operates waste-to-energy plants and expects to double the total installed capacity to 105 MW by year-end 2009, investing about €225 million. The additional capacity is expected to enhance the operating margin of the division, which was 27.5% at Sept. 30, 2006, and which Hera believes could reach 37% by 2009. A further €230 million is expected to be dedicated to increase treatment capacity by 20%.

Gas. Customers served and volumes sold and distributed significantly increased during the first nine months of 2006, primarily thanks to the acquisition and consolidation of Meta. Hera sold 1.7 billion cubic meters (bcm) and distributed 1.5 bcm over the period. Hera aims to defend its position and increase volume to 2.9 bcm by 2009. The company's main efforts are directed at reducing its dependence on Eni, which currently accounts for about 75% of Hera's procurement. To this end, Hera is seeking to increase recourse to alternative long-term and spot contracts, as well as to participate in pipeline and liquefied-natural-gas terminal projects. In particular, Hera is one of the partners in the Galsi pipeline project, and has recently signed an agreement with Algeria's state-owned gas group Sonatrach by which it will import 1 bcm of gas annually for 15 years, starting in 2010 or 2011, when the Galsi pipeline becomes operational. Gas capital expenditures for the next four years are limited to about €130 million, and mostly related to network maintenance, excluding infrastructure investments. Hera's financial commitment in infrastructure projects is expected to involve only limited equity contributions, however.

Water. Hera's water operations cover 170 Italian municipalities with a total of about 2.3 million inhabitants increasing to more than 5 million in the summer, owing to tourism. According to an agreement signed with the local authorities, Hera should invest a total of about €370 million in maintenance capital expenditures over the 2006-2009 period, compensated by an annual increase in tariffs of about 4.5%, which Hera believe could lead to an overall improvement in the division's operating margin to 37% by year-end 2009, from 27% at year-end 2005. Network quality is good, with leakages at about 23%, well below the Italian average of about 40%.

Electricity. Electricity's contribution to total EBITDA increased significantly after the merger with Meta and the purchase of Enel's network in the province of Modena. Hera's investment in the electricity sector is forecast at about €280 million over 2006-2009, with €107 million in 2006 for the acquisition of Enel's grid ar the balance devoted mainly to the construction of mostly gas-fired generation plants in which Hera owns various stakes. The company expects to reach about 9 terawatt-hours of sales at year-end 2009 and aims t almost halve its short position, reaching 75% coverage of sales with owned or contracted capacity. Its approach to electricity remains opportunistic, however, as it is viewed primarily as a product through which integrate gas offers and thereby propose more attractive commercial packages.

Competitive position/Profitability

Hera's competitive position is supported by its high proportion of low-risk regulated activities carried out under long-term concessions, strong local franchise, and good operational track record. Greater challenges are presented in gas--due to near-term concession expiry and lack of independence on the supply side--an electricity, where market liberalization is leading to increasing competition.

Financial Risk Profile

Accounting

Hera reports quarterly and adopted IFRS in 2005 without any major impact. Some moderate changes affected fixed-asset valuations, goodwill, site restoration provisions, capitalization of leases, and derivatives (which the company uses for interest rate hedging).

Standard & Poor's adjustments to Hera's reported figures are set out in the following table:

Table 2

Reconciliation Of Hera SpA 2005 Reported Amounts With Standard & Poor's Adjusted Amounts*

(Mil. €)

	Short- and long-term debt	Shareholders' equity	Revenues	Oper. income (before D&A)	Oper. income (before D&A)	Oper. income (after D&A)	Interest expenses	Operating cash flows	Operating cash flows	Capit expenditur
Hera SpA reported amounts										
	1,229.8	1,452.9	1,765.5	321.0	321.0	178.4	33.9	(16.3)	(16.3)	331
Standard & Poor's adjustments										
Operating leases	45.3	--	--	10.0	1.5	1.5	1.5	8.5	8.5	9
Postretirement benefit obligations	101.6	--	--	--	--	--	1.9	(0.1)	(0.1)	
Additional items included in debt	86.0	--	--	--	--	--	--	--	--	
Surplus cash and near cash investments	(189.1)	--	--	--	--	--	--	--	--	
Power purchase agreements	82.0	--	--	2.8	2.8	2.8	2.8	--	--	
Asset retirement	52.0	--	--	--	--	--	--	--	--	

	Debt	Equity	Revenues	Oper. income (before D&A)	EBITDA	EBIT	Interest expenses	Operating cash flows	Funds from operations	Capital expenditure
obligations										
Reclassification of nonoperating income	--	--	--	--	--	20.4	--	--	--	
Reclassification of working-capital cash flow changes	--	--	--	--	--	--	--	--	156.9	
Minority interests	--	30.6	--	--	--	--	--	--	--	
Meta consolidation	--	--	335.0	65.0	65.0	37.0	--	160.8	160.8	
Standard & Poor's total adjustments	177.8	30.6	335.0	77.8	69.3	61.7	6.2	169.2	326.1	9

Standard & Poor's adjusted amounts

Debt	Equity	Revenues	Oper. income (before D&A)	EBITDA	EBIT	Interest expenses	Operating cash flows	Funds from operations	Capit expenditur
1,407.6	1,483.5	2,100.5	398.8	390.3	240.1	40.0	152.9	309.8	340

*This table illustrates the adjustments made by Standard & Poor's to the company's reported amounts for the year ended Dec. 31, 2005. The first section headed "Hera SpA reported amounts" describes and shows amounts as reported by the company. The second section, headed "Standard & Poor's adjustments," shows our adjustments to these reported amounts. The third section, headed "Standard & Poor's adjusted amounts," describes and shows the amounts we use to calculate the fully adjusted ratios appearing elsewhere in this report. Please note that two reported amounts (operating income before D&A, and operating cash flows) are used to derive more than one Standard & Poor's-adjuste amount (operating income before D&A and EBITDA, and operating cash flows and funds from operations, respectively). Consequently, the fir section in some tables may feature duplicate descriptions and amounts.

Corporate governance/Risk tolerance/Financial policies

Hera is committed to maintaining a sound financial structure, but, at the same time, is exposed to the risk o increasing leverage due to its acquisitive appetite. The company does not have financial or rating targets, b would prefer to maintain its long-term rating in the 'A' category.

In addition, Hera's dividend policy is aggressive. Management is committed to a 15% annual increase in dividends until (and including) 2009, corresponding to a dividend pay out ratio exceeding 85%. The compar also announced a share buyback program in April 2006, albeit limited to €45 million, which would be used f share swaps in small mergers.

Cash flow adequacy

In September 2006, Hera presented its annual business plan update, according to which it expects to generate €650 million in EBITDA by year-end 2009. Most of the growth will be fueled by synergies and organic growth, with the remainder resulting from the contribution from new plants. The company has a goc track record in integrating acquired companies and taking advantage of synergies, and organic growth will I supported by the increase in tariffs. The most challenging aspects of the business plan will be the performance of the gas and electricity segments, given the tougher competition in both sectors.

Higher-than-expected working-capital needs in 2005 due to invoicing delays related to the implementation (a new billing system resulted in a build-up in accounts receivable and weaker cash flow that year as well as in the first part of 2006. Hera has tackled the issue, however, and working capital has been partially reabsorbed; usual working-capital levels should be achieved by year-end 2007.

At the current rating level, we expect FFO to adjusted debt to be slightly above 20% in the short term and t progress to about 25% in a couple of years, barring material debt-financed M&A activity.

Capital structure/Asset protection

We view Hera's capital structure as adequate overall. The balance between short- and long-term debt substantially improved following the issuance of a 10-year fixed-rate €500 million bond at the beginning of 2006. At Sept. 30, 2006, Hera reported €292 million in short-term debt and €1.1 billion in long-term obligations. There is no currency risk, and interest rate risk has been substantially mitigated through fixed-rate debt and hedging, so that all outstanding long-term debt is currently at fixed rates.

Hera's debt is unsecured, except for an €85 million (at year-end 2005) project finance loan granted to 51%-controlled subsidiary Fea Srl. We do not apply any structural subordination to the Hera parent company because it is an operating holding company that retains the concessions, owns material operating assets, and centralizes debt management.

Table 3

Hera SpA Peer Comparison*

	--Year ended Dec. 31, 2005--			--Year ended Sept. 30, 2006--
(Mil. €)	**Hera SpA**	**Acea SpA**	**EWE AG**	**EVN AG**
Corporate credit rating¶	A/Stable/A-1	A/Stable/A-1	A/Stable/--	A/Stable/--
Total revenues	2,100.5	1,624.4	5,546.1	1,651.0
Net income from continuing operations	80.3	101.6	110.6	144.4
Funds from operations (FFO)	309.8	294.9	474.1	297.2
Capital expenditures	340.3	268.8	310.6	128.6
Cash and investments	0.0	53.4	54.0	351.4
Debt	1,407.6	1,403.1	2,544.9	1,022.9
Common equity	1,452.9	1,263.5	590.4	2,017.5
Total capital	2,891.2	2,706.8	3,143.5	3,231.6
EBIT interest coverage (x)	6.0	3.4	4.9	3.6
FFO interest coverage (x)	8.5	4.6	4.4	5.5
FFO/debt (%)	22.0	21.0	18.6	29.1
Net cash flow/capex (%)	75.6	82.4	132.8	200.9
Debt/total capital (%)	48.7	51.8	81.0	31.7

*Fully adjusted (including postretirement benefit obligations). Excess cash and investments netted against debt. ¶As of Feb. 20, 2007.

Table 4

Hera SpA Financial Statistics

(Mil. €)	**2005**	**2004**
Total revenues	2,100.5	1,519.7
Operating income (before D&A)	398.8	305.7
EBITDA	390.3	297.4
Operating income (after D&A)	219.7	182.2
Net income from continuing operations	80.3	81.0
Funds from operations (FFO)	309.8	215.3
Cash flow from operations	152.9	205.1
Capital expenditures (capex)	340.3	234.5
Free operating cash flow (FOCF)	(187.5)	(29.4)
Cash and investments	0.0	0.0
Debt	1,407.6	948.8
Net pension and postretirement deficit (after tax)	101.6	80.7
Total liabilities	2,621.1	1,840.3
Preferred stock	0.0	0.0
Common equity	1,452.9	1,035.9
Total capital	2,891.2	2,013.0
Annual sales growth (%)	38.2	14.2
Operating income (before D&A)/sales(%)	19.0	20.1
Operating income (after D&A)/sales(%)	10.5	12.0
FOCF/sales (%)	(8.9)	(1.9)
Net cash flow/capex (%)	75.6	91.8
Return on common equity (%)	6.5	8.5
Return on capital (%)	9.5	10.5
Common dividend payout ratio (%)	88.6	65.0
EBIT interest coverage (x)	6.0	6.1
EBITDA interest coverage (x)	9.7	9.8
FFO interest coverage (x)	8.5	7.8
Cash flow from operations interest coverage (x)	4.6	7.5
FFO/debt (%)	22.0	22.7
Cash flow from operations/debt (%)	10.9	21.6
FOCF/debt (%)	(13.3)	(3.1)
Debt/EBITDA (x)	3.6	3.2

Debt/total capital (%)	48.7	47.1

Ratings Detail (As Of 20-Feb-2007)*

Hera SpA	
Corporate Credit Rating	A/Stable/A-1
Senior Unsecured	
Local Currency	A
Corporate Credit Ratings History	
21-Dec-2006	A/Stable/A-1
26-Jan-2006	A+/Negative/A-1
25-Jan-2005	A+/Stable/A-1
Business Risk Profile	1 2 3 **4** 5 6 7 8 9 10
Financial Risk Profile	Moderate

Debt Maturities

Long-term debt maturities
2007: €98 mil.
2008: €96 mil.
2009: €92 mil.
2010: €83 mil.
2011: €49 mil.
2012: €25 mil.
Thereafter: €577 mil.

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

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