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Research Update:

Italian Utility Hera SpA Downgraded To 'BBB+' On Weakened Financial Profile; 'A-2' Rating Affirmed; Outlook Stable

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Overview

- Increasing levels of debt and the economic downturn have weakened the credit metrics of Italy-based utility Hera SpA.
- Hera's creditworthiness is no longer commensurate with what we consider adequate of the previous 'A-' rating.
- We are therefore lowering the long-term corporate credit rating on Hera to 'BBB+' from 'A-'.
- The stable outlook reflects our view that Hera should be able to sustain FFO to debt above 15% in the medium term.

Rating Action

On June 23, 2010, Standard & Poor's Ratings Services lowered its long-term corporate credit rating on Italian utility Hera SpA to 'BBB+' from 'A-'. At the same time, the short-term corporate credit rating on Hera was affirmed at 'A-2'. The outlook is stable.

Rationale

The downgrade reflects our view of the deterioration of Hera's credit metrics. Although the company was able to improve cash flow generation in 2009 compared with 2008, this was offset by a higher amount of debt, preventing a sufficient recovery of Hera's financial profile. The previous long-term rating of 'A-' on Hera assumed a recovery in the ratio of FFO to debt to 20% by 2010. However, adverse macroeconomic conditions, combined with a worsening in working capital, saw this ratio dip to 14.9% in 2009, from 15.6% in 2008.

The ratings on Hera reflect the company's strong business profile. This profile is underpinned by a well-balanced portfolio to which low-risk monopoly-regulated operations contribute about 60% of EBITDA, although we anticipate that its share of regulated operations will likely fall to about 50% in 2013. The ratings also take into account Hera's strong franchise in the wealthy and populated northern Italian Region of Emilia-Romagna (A+/Stable/--), its dominant position in waste management as well as in water, and its strong position as a gas supplier in Italy. However, these positive factors are offset by Hera's involvement in the riskier electricity generation and trading business, a weakened financial profile, and what we see as an aggressive dividend policy.

In accordance with Standard & Poor's Ratings Services' criteria for government-related entities (GRE), our view of a "low" likelihood of extraordinary government support, which has no consequence for Hera's rating, is based on our assessment of the:

- "Limited Importance" role of Hera for the municipal shareholders. Although Hera is a major provider of public services, making it strategically important for the municipal shareholders, its activities could, in our opinion, be undertaken by a private sector entity if Hera ceased to exist.
- "Limited" link between Hera and its municipal shareholders, given fragmented ownership and the potential decision-making difficulties we see as a result of Hera's shareholder structure and governance model. The municipal ownership is split between 180 small local municipalities with the Region of Emilia-Romagna.

Liquidity

We consider Hera's liquidity as adequate. As of March 31, 2010, the company reported €320 million of cash and had €480 million available under five undrawn committed credit lines maturing between November 2010 and June 2012. Maturing debt amounts to €166 million in the next two years.

Hera expects to be slightly cash flow negative in 2010 and 2011 and then broadly cash neutral. Planned investments in 2010-2013 total approximately €1.3 billion, of which we believe about 50% is for development capital expenditures, giving a degree of flexibility.

As regards covenants, we understand most of Hera's 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.

Hera has issued about €400 million of bonds with put options in 2007 and 2008, with the next put of €100 million exercisable in 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 stable outlook reflects our opinion that over the medium term, Hera should maintain a financial profile commensurate with the 'BBB+' rating, specifically FFO to debt above 15% on a sustainable basis. There is, however, no headroom for any deterioration in the company's operational and financial performance because Hera's 2009 financial performance is below the 15% level.

The ratings do not factor in material changes in business risk, mergers and acquisitions, or changes in financial (including dividend) policies.

In our opinion, there is currently limited rating upside owing to Hera's weakened financial profile.

Related Criteria And Research

- Principles Of Corporate And Government Ratings, June 26, 2007
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Business Risk/Financial Risk Matrix Expanded, May 27, 2009
- Enhanced Methodology And Assumptions For Rating Government-Related Entities, June 29, 2009

Ratings List

	To	From
Downgraded; CreditWatch/Outlook Action; Ratings Affirmed		
	To	From
Hera SpA		
Corporate Credit Rating	BBB+/Stable/A-2	A-/Negative/A-2
Senior Unsecured Debt	BBB+	A-

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Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.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) 495-783-4011.