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Research Update: Italian Utility Hera Sees Outlook Revised To Negative On Concerns Over Financial Profile

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Credit Rating: A+/Negative/A-1

Rationale

On Jan. 26, 2006, Standard & Poor's Ratings Services revised its outlook on Italian multiutility Hera SpA to negative from stable. At the same time, the 'A+' long-term and 'A-1' short-term corporate credit ratings were affirmed.

The outlook revision reflects Standard & Poor's concern about Hera's ability to maintain an adequate financial profile for the current ratings, owing to higher-than-expected debt--primarily related to an increase in working capital following the introduction of a new billing system--resultant weaker credit metrics, the potential for operating underperformance, and the risk of debt-funded credit-dilutive acquisitions.

The ratings reflect the company's strong business profile, underpinned by a well-balanced activity portfolio to which low-risk regulated operations contribute significantly. They also take into account Hera's strong franchise in the wealthy region of Emilia-Romagna (AA-/Negative/--), and the possibility of synergies from the group's business model.

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

Hera is Italy's largest regional utility, serving about 70% of Emilia-Romagna, the country's third-wealthiest region. The company's main business lines are waste management (37% of gross operating income in the year ended Sept. 30, 2005), water (29%), and gas (27%). This well-diversified portfolio, with balancing seasonality features and a strong contribution from low-risk regulated activities, supports Hera's credit quality.

At year-end 2005 Meta merged with Hera, enabling the latter to increase its revenue base and scale by about 20% and expand its electricity operations. Standard & Poor's expects the combination to be positive from a business perspective, given the two companies' geographic proximity and the similarity of their portfolios. This should strengthen Hera's competitive position and enable synergies, with benefits in procurement, grid management, and holding functions. Improving gas procurement is particularly important for energy supply operations, which are exposed to increasing competition.

Since the transaction was partially debt-financed, however, it negatively affected Hera's financials, resulting in a debt increase of about €120 million on the €778 million reported at end-September 2005. Debt levels were also negatively affected in 2005 by higher-than-expected working capital, estimated at about €80 million, arising from the impact of a newly introduced billing system, which the company plans to fix by 2007. The company expects debt to increase further in 2006, due to planned capital expenditures, but decline thereafter.

Liquidity

Liquidity is adequate, with about €155 million in cash at Dec. 31, 2005, and almost €160 million in unused committed credit lines, maturing in one year. About €440 million in debt will mature in 2006, but this short-term concentration will be reduced, thanks to an upcoming €500 million bond issue. Financial covenants are only included in certain loans and do not currently pose material liquidity concerns.

Outlook

The negative outlook is based on our perception that, in part owing to industry development, Hera's risk of operational underperformance has heightened, particularly in the areas of gas, electricity, and working-capital management. In addition, there is ongoing risk of further M&A activity and slightly increasing shareholder remuneration. These factors may prevent Hera from maintaining an adequate financial profile for the ratings, which factor in a substantial improvement after the deterioration expected in 2006. The ratings could be lowered in the near term if coverage of debt by funds from operations (FFO) declines markedly below 25% or if there is any operating underperformance or further credit-dilutive acquisitions/investments. To revise the outlook back to stable, Standard & Poor's would need to feel comfortable that Hera would be able to strengthen its FFO debt coverage to close to 30% over the next couple of years.

Ratings List

	To	From
Corporate credit rating	A+/Negative/A-1	A+/Stable/A-1

Additional Contact: Infrastructure Finance Ratings Europe;
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Ratings information is available to subscribers of RatingsDirect, Standard & Poor's Web-based credit analysis system, at www.ratingsdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office Hotline (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4017. Members of the media may also contact the European Press Office via e-mail on: media_europe@standardandpoors.com.