STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Research

Hera SpA

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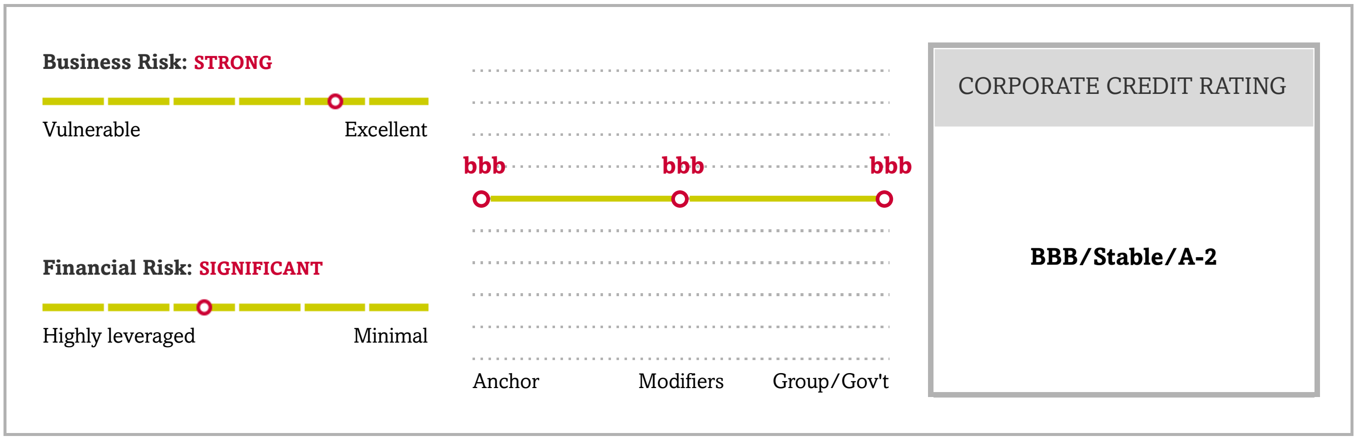
Hera SpA



Rationale

Business Risk

- Well-balanced portfolio of utility services, with the share of low-risk regulated activities exceeding 50% of EBITDA in our 2015-2017 rating horizon.
- Dominant position in waste and water management in northeast Italy and a leading position among gas suppliers in Italy.
- Highly acquisitive growth strategy, but with a minor impact on debt.

Financial Risk

- Aggressive dividend distributions.
- Our anticipation of neutral cash flow after capital expenditures and dividends.

Outlook

The stable outlook on Italian multi-utility Hera SpA reflects Standard & Poor's Ratings Services' expectation that the company will achieve and sustain adjusted funds from operations (FFO) to adjusted debt of 18%, which we see as commensurate with Hera's "significant" financial risk profile. 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.

Downside scenario

We could lower the ratings if we considered that Hera could struggle to achieve and maintain adjusted FFO to debt of about 18% over the next 24 months. This could occur if Italy's market and industry conditions do not recover, jeopardizing Hera's commitment to maintaining neutral cash flow generation after capital expenditures (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 take a positive rating action if Hera's financial risk profile strengthened beyond our expectations. A sustainable adjusted FFO-to-debt ratio of about 23% is commensurate with a higher rating, assuming no further change in the ratings on Italy or in our assessment of Hera's business risk.

Standard & Poor's Base-Case Scenario

Assumptions

- Inflation rate of about 1%, translating into average revenue growth of 4% and EBITDA growth of about 1%;
- Capex of about €1.4 billion over 2015-2017, including resources to retender existing gas concessions;
- An average of €130 million disbursed for dividend payments annually;
- An average debt cost of 3.9%; and
- A 100 basis-point reduction in nominal pretax weighted average cost of capital for power, and gas distribution, affecting revenues from 2016 on a cumulative regulated asset base of €2 billion.

Key Metrics

	2014a	2015e	2016e	2017e
Adjusted FFO/debt (%)*	19.1	18-19	18-19	19-20
Debt to EBITDA (x)*	3.8	3.7-3.9	3.6-3.8	3.6-3.8

*Fully Standard & Poor's-adjusted. a--Actual. e--Estimate. FFO--Funds from operations.

Company Description

Hera is an Italian multi-utility operating with a diversified portfolio, characterized by a predominance of regulated and quasi-regulated businesses (more than 50% of 2014 EBITDA) and liberalized activities. The company operates mainly in:

- Electricity and power supply and trading;
- Electricity, gas distribution, and district heating;
- Environmental services (contract-based waste collection and treatment); and
- Integrated water services.

Hera was created in 2002 from the aggregation of a variety of local and regional small utilities formerly controlled by Italian municipal entities. Hera is listed but the majority of its capital is held by approximately 200 local and regional governments. Hera distributes natural gas to 1.7 million customers in the provinces of Bologna, Ravenna, Forlì-Cesena, Ferrara, Modena, Rimini, Florence, Padua, Trieste, Gorizia, and Udine and it distributes about 3.2 billion cubic meters of gas per year.

Business Risk

Hera's "strong" business risk profile takes into account the company's diversified portfolio of utility businesses in one of Italy's wealthiest regions and the group's dominant local market position. 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 (AEEGSI). These activities generate slightly more than 50% of Hera's EBITDA and could increase their contribution over 2015-2018, depending on the outcome of the gas-distribution retendering process, which will likely start this year.

Hera's ability to achieve growth in a challenging economic environment continues to support its "strong" business risk profile, in our view. In 2014, Hera integrated multi-utility Amga Udine into its consolidation scope, following the acquisition of ACEGAS APS in 2013. Provided Hera continues to carry out its acquisitive strategy through share swaps, and therefore does not impede the stability of our credit metrics on the company, we view Hera's proven skills in integrating new businesses and extracting cost synergies as supportive of the business risk profile. What's more, we see the company increasing market share in businesses we consider increasingly competitive, such as waste treatment and power and gas supply. Although we think that counterparty risk remains an issue for the majority of the rated Italian utilities, reflective of a relatively weak payment culture versus European standards, we believe that Hera's increasingly prudent management, coupled with the recognition of cost from bad debt by the regulator helps mitigate the risk.

Hera's strengths are partly offset by its almost exclusive exposure to country risk in Italy. Relative to European peers, particularly Austrian multi-utilities, Hera faces materially higher tax pressure and potentially higher funding costs.

Sluggish economic conditions in Italy might weigh on the profitability of Hera's activities particularly exposed to the business cycle, such as the waste segment. Standard & Poor's recently revised its economic forecast on Italy, including the expectation for a moderate economic recovery (see "Italy Is On A Weak Path To Economic Recovery," published Sept. 23, 2015, on RatingsDirect). Our anticipation of sluggish demand for power and gas until 2020, combined with increasing pressure on power and gas bills in Italy, will limit in our view the profitability of liberalized power and gas businesses. These weaknesses will be partly mitigated by the expected solid performance of regulated businesses in the water service area, thanks to a favorable tariff review, and to a lesser extent in the distribution of gas and electricity, where we expect a regulatory rest that could likely curtail the remuneration of regulated assets.

S&P Base-Case Operating Scenario

- Stable power and gas prices;
- A regulatory reset that will affect regulated revenues from 2016.
- We also expect that after the acquisition of Acegas APS and AMGA Udine (two multi-utilities operating in the northeastern part of Italy), Hera will focus its efforts on the potential takeover of AIMAG (local multi-utility) in which it holds 25%.

Peer comparison

Table 1

Hera SpA -- Peer Comparison					
Industry Sector: Utility Company					
	Hera SpA	**A2A SpA**	**Acea SpA**	**EnBW Energie Baden-Wuerttemberg AG**	**EVN AG**
Rating as of Oct. 29, 2015	BBB/Stable/A-2	BBB/Stable/A-2	BBB-/Stable/A-3	A-/Stable/A-2	BBB+/Stable/--
(Mil. €)	**--Average of past three fiscal years--**				
Revenues	4,446.6	5,689.3	3,306.4	21,089.6	2,391.6
EBITDA	766.2	1,048.7	585.8	2,230.6	540.0
Funds from operations (FFO)	524.0	745.1	395.1	1,352.0	486.8

Table 1

Hera SpA -- Peer Comparison (cont.)					
Net income from continuing operations	149.5	84.3	124.1	24.6	1.7
Cash flow from operations	454.7	781.0	451.9	1,838.0	563.7
Capital expenditures	309.1	322.7	377.5	1,073.1	269.5
Free operating cash flow	145.5	458.3	74.4	765.0	294.3
Dividends paid	128.5	80.3	56.4	337.4	110.2
Discretionary cash flow	17.0	378.0	18.0	427.5	184.1
Debt	3,036.4	4,521.1	2,826.6	7,205.3	2,279.6
Preferred stock	0.0	0.0	0.0	666.7	0.0
Equity	2,219.9	3,408.0	1,413.9	6,331.3	3,413.4
Debt and equity	5,256.3	7,929.1	4,240.5	13,536.6	5,693.0
Adjusted ratios					
EBITDA margin (%)	17.2	18.4	17.7	10.6	22.6
Return on capital (%)	8.7	6.8	8.0	11.3	3.3
EBITDA interest coverage (x)	5.3	4.7	4.9	2.4	5.1
FFO cash interest coverage (x)	4.4	6.2	4.2	6.1	8.3
Debt/EBITDA (x)	4.0	4.3	4.8	3.2	4.2
FFO/debt (%)	17.3	16.5	14.0	18.8	21.4
Cash flow from operations/debt (%)	15.0	17.3	16.0	25.5	24.7
Discretionary cash flow/debt (%)	0.6	8.4	0.6	5.9	8.1
Net cash flow/capex (%)	127.9	206	89.7	94.5	139.8
Return on capital (%)	8.7	6.8	8	11.3	3.3
Return on common equity (%)	7.6	3	9.5	(0.5)	(0.3)
Common dividend payout ratio (un-adj.) (%)	85.4	88.1	32.6	818.4	4,290.40

Financial Risk

Our assessment of Hera's financial risk profile as "significant" reflects our view of its aggressive dividend policy, combined with relatively weak credit metrics, namely adjusted FFO to debt of 19.1% and debt to EBITDA of 3.8x at year-end 2014. Hera's strategy is to improve its credit metrics by increasing operating cash flows over the next few years.

In our base-case scenario, however, we forecast that Hera will continue posting neutral to positive cash flow after capital expenditures and dividends over the next two to three years. In our view, this means that Hera has little room to maneuver, and less ability to reduce debt in a gloomy economic and industry environment.

However, prudent debt management, good access to the bond market, strong liquidity, and a good degree of cash flow predictability, determined by the high and potentially increasing share of regulated business in Hera's portfolio, partly mitigate these risks, in our view.

S&P Base-Case Cash Flow And Capital Structure Scenario

- We assume that future mergers or acquisitions will be financed via share swaps that would lead to a gradual dilution of municipal entities' control.
- Hera's shareholders will likely receive generous dividends in the coming years as per the company's policy of maintaining neutral cash flows.
- We expect Hera's revenues will grow at an annual average of 4%, with inflation remaining at about 1% in 2015-2017.

Financial summary

Table 2

Hera SpA -- Financial Summary					
Industry Sector: Utility Company					
	--Fiscal year ended Dec. 31--				
(Mil. €)	**2014**	**2013**	**2012**	**2011**	**2010**
Revenues	4,189.1	4,456.9	4,693.6	4,310.6	3,879.0
EBITDA	858.3	782.9	657.4	620.1	591.9
Funds from operations (FFO)	614.1	531.7	426.2	393.9	337.6
Net income from continuing operations	164.8	164.9	118.7	104.6	117.2
Cash flow from operations	527.6	518.5	317.9	372.3	300.7
Capital expenditures	334.8	310.0	282.5	331.9	347.4
Free operating cash flow	192.8	208.5	35.4	40.5	(46.6)
Dividends paid	137.4	131.3	116.8	117.2	98.3
Discretionary cash flow	55.4	77.1	(81.4)	(76.8)	(144.9)
Debt	3,192.5	3,215.6	2,701.2	2,474.2	2,398.9
Equity	2,459.0	2,305.7	1,894.9	1,879.3	1,870.2
Adjusted ratios					
EBITDA margin (%)	20.5	17.6	14.0	14.4	15.3
EBITDA interest coverage (x)	5.9	5.4	4.7	4.8	4.4
FFO cash interest coverage (x)	4.3	5.2	3.9	4.3	4.2
Debt/EBITDA (x)	3.7	4.1	4.1	4.0	4.1
FFO/debt (%)	19.2	16.5	15.8	15.9	14.1
Cash flow from operations/debt (%)	16.5	16.1	11.8	15.0	12.5
Free operating cash flow/debt (%)	6.0	6.5	1.3	1.6	(1.9)
Discretionary cash flow/debt (%)	1.7	2.4	(3.0)	(3.1)	(6.0)
Net cash flow /capex (%)	142.4	129.1	109.5	83.4	68.9
Return on capital (%)	9.0	8.8	8.4	8.2	7.8
Return on common equity (%)	7.4	8.4	6.8	5.9	6.7
Common dividend payout ratio (un-adj.) (%)	83.4	79.6	96.1	116.1	85.6

Liquidity

We assess Hera's liquidity as "strong" according to our criteria. In our view, the company's planned cash outlays--mainly capex, debt service, and dividends--will be covered by available cash, committed credit lines with maturities exceeding 12 months, and our expectation of FFO above 1.5x in the following 12 months.

Principal Liquidity Sources

- Access to unrestricted cash of more than €425 million as of June 30, 2015;
- Access to available undrawn committed credit lines of €445 million as of June 30, 2015, maturing after 12 months; and
- Our forecast that Hera will generate cash FFO of more than €638 million in the next 12 months.

Principal Liquidity Uses

- €380 million of capex;
- Dividend outflows of approximately €130 million; and
- Debt maturities exceeding €420 million over the next 12 months.

Other liquidity factors:

- Sufficient covenant headroom for forecast EBITDA to decline by 30% without the company breaching coverage tests;
- Ability to absorb high-impact, low-probability events, and limited need for refinancing;
- Sound bank relationships; and
- Solid standing in credit markets.

Debt maturitiesas of June 30, 2015

- 2015: €419.8 million
- 2016: €85.3 million
- 2019 and thereafter: €2,095.2 million
- Total: €3,642.6 million

Covenant Analysis

We understand that Hera's committed lines and financial agreements do not include covenants.

Rating Above The Sovereign

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.

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-
- **Rating above the sovereign:** (-1 notch from SACP)

Reconciliation

Hera reports according to International Financial Reporting Standards, therefore:

- We adjust reported debt by the present value of operating leases, postretirement obligations, asset-retirement obligations, the present value of payments committed under purchase price agreements and guarantees, and by the average outstanding trade receivables sold.
- We do not apply a haircut to Hera's liquidity because we consider that there's no evidence of constraint on its existing liquidity position.

Table 3

Reconciliation Of Hera SpA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €)

	--Fiscal year ended Dec. 31, 2014--							
Hera SpA reported amounts								
	Debt	**Shareholders' equity**	**EBITDA**	**Operating income**	**Interest expense**	**EBITDA**	**Cash flow from operations**	**Capital expenditures**
Reported	3,671.4	2,310.9	867.8	441.2	132.8	867.8	507.3	329.5
Standard & Poor's adjustments								
Interest expense (reported)	--	--	--	--	--	(132.8)	--	--

Table 3

Reconciliation Of Hera SpA Reported Amounts With Standard & Poor's Adjusted Amounts (Mil. €) (cont.)								
Interest income (reported)	--	--	--	--	--	21.5	--	--
Current tax expense (reported)	--	--	--	--	--	(122.0)	--	--
Trade receivables securitizations	86.9	--	--	--	4.4	(4.4)	2.2	--
Operating leases	68.0	--	16.8	4.8	4.8	12.0	12.0	--
Postretirement benefit obligations/deferred compensation	158.7	--	--	--	3.2	(4.2)	2.5	--
Surplus cash	(834.5)	--	--	--	--	--	--	--
Dividends received from equity investments	--	--	11.1	--	--	11.1	--	--
Nonrecourse debt	(45.1)	--	--	--	--	--	--	--
Power purchase agreements	59.6	--	9.5	4.2	4.2	5.3	5.3	5.3
Asset retirement obligations	70.1	--	--	--	7.4	(3.9)	(1.7)	--
Non-operating income (expense)	--	--	--	32.5	--	--	--	--
Non-controlling Interest/Minority interest	--	148.1	--	--	--	--	--	--
Debt - Guarantees	22.0	--	--	--	--	--	--	--
Debt - Derivatives	(64.7)	--	--	--	--	--	--	--
EBITDA - Gain/(Loss) on disposals of PP&E	--	--	3.7	3.7	--	3.7	--	--
EBITDA - Other income/(expense)	--	--	(65.5)	(65.5)	--	(65.5)	--	--
EBITDA - Other	--	--	14.9	14.9	--	14.9	--	--
D&A - Other	--	--	--	65.5	--	--	--	--
Interest expense - Derivatives	--	--	--	--	(10.4)	10.4	--	--
Total adjustments	(478.9)	148.1	(9.5)	60.1	13.6	(253.8)	20.2	5.3
Standard & Poor's adjusted amounts								
	Debt	**Equity**	**EBITDA**	**EBIT**	**Interest expense**	**Funds from operations**	**Cash flow from operations**	**Capital expenditures**
Adjusted	3,192.5	2,459.0	858.3	501.4	146.4	614.1	527.6	334.8

PP&E--Property, plant, and equipment. D&A--Depreciation and amortization.

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013

- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Ratings Above The Sovereign—Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Use Of CreditWatch And Outlooks, Sept. 14, 2009
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	**bbb**	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of October 29, 2015)

Hera SpA	
Corporate Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB
Corporate Credit Ratings History	
12-Jul-2013	BBB/Stable/A-2
26-Apr-2013	BBB+/Negative/A-2
23-Jun-2010	BBB+/Stable/A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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