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Research Update:

Italian Multi-Utility Hera Outlook Revised To Positive On Stronger Credit Metrics; 'BBB/A-2' Ratings Affirmed

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Overview

- In our view, Hera's credit metrics could continue improving, thanks to solid business fundamentals over the coming two years, following a good financial performance in 2017.
- Hera's investments in its regulated gas and water distribution operations, soon-to-be-regulated waste treatment activities, and value-adding bolt-on acquisitions should lead to a gradual increase of EBITDA in 2018.
- We are therefore revising our outlook on Hera to positive from stable and affirming our 'BBB/A-2' ratings.
- The positive outlook indicates that we could raise the ratings if EBITDA growth, a supportive dividend policy, and positive discretionary cash flow lead to a sustained improvement in Hera's credit metrics, with funds from operations to debt staying above 23%.

Rating Action

On March 13, 2018, S&P Global Ratings revised its outlook on Italian multi-utility company Hera SpA to positive from stable. We affirmed our 'BBB/A-2' long- and short-term issuer credit ratings on the company.

Rationale

The outlook revision follows Hera's good operating performance in 2017, with reported EBITDA estimated at about €980 million and funds from operations (FFO) to debt expected to be slightly above 23%. This is up from reported EBITDA of €917 million and adjusted FFO to debt of 21% in 2016. Hera's healthy growth prospects, combined with the sound implementation of its updated business plan, could lead to a sustainable improvement in credit metrics, with FFO to debt staying above 23%.

We believe that Hera is committed to strengthening its credit standing while implementing its growth strategy. An improvement of cash flow metrics also depends on a disciplined dividend policy and cash acquisition transactions. We note, however, that some uncertainties from economic conditions in Italy after the recent national elections could overshadow the company's healthy business development (see "Italy's General Election Outcome Has No Immediate Effect On The Sovereign Rating," published March 5, 2018, on RatingsDirect). Yet we believe Hera's businesses are relatively well positioned to withstand these uncertainties for the time being.

Hera is one of Italy's largest multi-utility companies, active in waste management; water provision, sewerage, and purification; and energy (electricity, gas distribution and sales, energy services). Hera operates mainly in the Emilia-Romagna region, as well as several neighboring regions. The group, listed on the Milan stock exchange, had a market capitalization of €4.4 billion on March 9, 2018. We believe Hera's business model is resilient to market conditions, thanks to its very balanced portfolio. It derives about half of its EBITDA from regulated activities (water, gas, and power distribution), which we view as positive (see "Why We See Italy's Electricity And Gas Regulatory Frameworks As Supportive," published Nov. 30, 2017). About 25% of EBITDA comes from waste management and treatment and 25% from energy supply, for which the company has built a track record with 2.3 million customers at year-end 2016. In addition, Hera's negligible exposure to upstream energy supports the stability and predictability of its business model compared with that of peers, notably A2A.

Moreover, we regard the group's operating track record, solid management team, and proven capacity to expand through small acquisitions as positive. The group also demonstrates good debt management through a smooth debt repayment profile and solid free cash flow generation, even after dividends.

In our view, Hera's business plan for 2017-2021 will likely continue supporting its business risk profile:

- We expect about 65% of investment spending of the planned €2.9 billion will be on low-risk regulated activities, which will be the main growth engine. According to the plan, more than €450 million of capital expenditure (capex) will be allocated to gas tenders to further strengthen Hera's presence in this key area.
- Hera could benefit from new regulation for Italy's fragmented waste sector, which could lead to an increase in long-term contracted EBITDA and visibility of cash flow generation, alongside new tenders.
- Downstream free-market business could increase, given Hera's target of expanding its free-market customer base by 200,000 customers yearly. Despite mounting competition, we believe this is achievable, considering that clients will be seeking a free-market provider once the market is fully deregulated at the end of 2019.
- €380 million in acquisition spending from 2017-2021, of which €120 million was incurred in 2017 for Aliplast. This should support EBITDA growth, while increasing Hera's debt through consolidation of the acquired companies' obligations.

We forecast that Hera will post steadily increasing EBITDA over 2018-2020, backed by internal growth and bolt-on acquisitions. The improvement in ratios depends on Hera's generation of materially positive cash flow after capex and dividends and a disciplined financial policy.

In our base case for 2018-2020, we assume:

- Revenues increasing by 1.5% yearly.
- Reported EBITDA improving by about a compound annual growth rate of 2% to about €1.1 billion by 2020, from €917 million in 2016 and €980 million in 2017.
- A stable reported EBITDA margin of about 20.5%.
- Current taxes of €110 million-€130 million.
- Negative changes in working capital by €10 million-€20 million.
- Annual capex of €500 million, up from close to €400 million in 2017 and €384 million in 2016.
- Total acquisition spending of about €200 million and debt intake of €160 million-€170 million.
- A potential cash dividend increase to €160 million-€170 million, owing to share swaps resulting from acquisition transactions. Any changes in the dividend policy would weigh on the ratings.
- Net reported debt of €2.7 billion-€2.8 billion.

Based on these assumptions, we arrive at the following credit measures for Hera in 2018-2020:

- Debt to EBITDA markedly below 3.5x.
- FFO to debt above 23%.
- Positive cash flow from operations after capex and dividends.

Liquidity

Hera's liquidity is strong, in our view. The company's planned available cash and committed credit lines cover cash outlays--mainly capex, debt service, and dividends--by more than 1.5x over the 12 months started Jan. 1, 2017, and by more than 1.0x over the following 12 months.

Furthermore, Hera has a high credit standing in the capital markets, strong relationships with banks, and solid and prudent risk management.

Principal liquidity sources as of Jan. 1, 2018, include:

- Our estimate of about €450 million in unrestricted cash;
- Available undrawn committed credit lines of €410 million maturing beyond 12 months, which reduce to about €285 million over the following 12 months. Hera also has €125 million in committed lines maturing in less than 12 months that we understand it will renew; and
- Our forecast of more than €770 million of cash FFO over the next 12

months and about €800 million in the subsequent 12 months.

Principal liquidity uses as of the same date:

- Debt maturities of €244 million in 2018 and €448 million in 2019;
- Negative working capital outflow of €15 million-€20 million annually for the coming two years;
- Capex of €500 million per year, including €350 million of maintenance capex;
- Dividend outflows of €160 million-€170 million per year; and
- Acquisition spending of €60 million-€70 million yearly.

Outlook

The positive outlook indicates the possibility of an upgrade in the next 12-18 months if Hera's EBITDA keeps strengthening alongside stable profitability, fostered by increasing investments in regulated or quasi-regulated activities, disciplined dividend and acquisition policies, and positive discretionary cash flow generation. These should lead to a sustained improvement in credit metrics.

Upside scenario

We could raise the ratings if Hera maintains its sound financial performance while deploying its investment plan and generating healthy cash flow after capex and dividends. This should translate into EBITDA improving constantly toward €1 billion during 2018, while FFO to debt stays above 23%. An upgrade is also dependent on Hera adhering to a prudent financial policy.

An upgrade of Hera is also dependent on our unsolicited rating on Italy remaining at 'BBB'. The Italian utilities sector is highly sensitive to the sovereign's creditworthiness. However, we could rate Hera up to two notches higher than Italy, provided we are confident that the company can withstand a hypothetical sovereign default scenario.

Downside scenario

We could revise the outlook to stable over the next 12-18 months if Hera's FFO to debt stabilizes below 23%. This could happen for example, if:

- Hera undertook larger cash acquisitions or increased its dividend, deviating from what we would view as prudent financial policy;
- The economic environment in Italy turned negative, thereby constraining Hera's growth strategy; or
- Changes in the regulatory framework for Hera's network business (water, gas, and electricity) were to impede the company's ability to achieve its EBITDA targets.

We could also take a negative rating action on Hera following similar action on the sovereign.

Ratings Score Snapshot

Issuer Credit Rating: BBB/Positive/A-2

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

Financial risk:
- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers
- Diversification/Portfolio effect: Neutral (No impact)
- Capital structure: Neutral (No impact)
- Liquidity: Strong (No impact)
- Financial policy: Neutral (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

Issue Ratings--Subordination Risk Analysis

Capital structure

At year-end 2016, Hera's capital structure comprised about €3.2 billion of gross debt, almost all of which was unsecured.

Analytical conclusions

We rate Hera's senior unsecured debt 'BBB', the same as the issuer credit rating, since there are no significant elements of subordination risk in the capital structure.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- 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
- 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
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, 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: 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. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Italy's General Election Outcome Has No Immediate Effect On The Sovereign Rating, March 5, 2018
- Why We See Italy's Electricity And Gas Regulatory Frameworks As Supportive , Nov. 30, 2017

Ratings List

Ratings Affirmed; Outlook Action

	To	From
Hera SpA		
Issuer Credit Rating	BBB/Positive/A-2	BBB/Stable/A-2
Senior Unsecured	BBB	BBB

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