STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

Research

Summary:
Hera SpA

Primary Credit Analyst:
Vittoria Ferraris, Milan (39) 02-72111-207; vittoria.ferraris@standardandpoors.com

Secondary Contact:
Tuomas E Ekholm, CFA, Frankfurt (49) 69-33-999-123; tuomas.ekholm@standardandpoors.com

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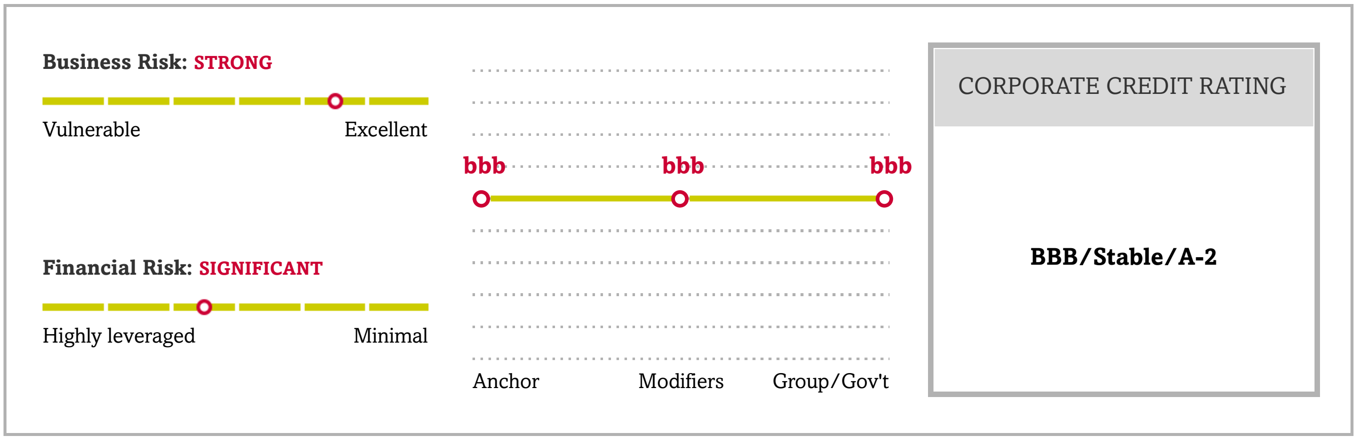
Summary:

Hera SpA



Rationale

Business Risk: Strong	Financial Risk: Significant
• Well-balanced portfolio of utility services with a 50% share of low-risk regulated activities. • Dominant regional position in waste and water management and a leading position among gas suppliers in Italy. • Service provider to prosperous regions in Italy. • Exposure to increased country risk in Italy and low economic growth. • Highly acquisitive growth strategy with neutral impact on debt.	• Aggressive dividend distributions. • Relatively weak but gradually improving credit metrics. • Our anticipation of neutral cash flow after capital expenditures and dividends.

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Outlook: Stable

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 commensurate with Hera's "significant" financial risk profile. The outlook also reflects our belief that the Republic of Italy (unsolicited BBB/Negative/A-2) does not fully constrain Hera's creditworthiness at the current rating level.

Downside scenario

We could lower the rating if we consider that Hera could struggle to achieve and maintain adjusted FFO to debt of approximately 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 expenditure (capex) and dividends. We would also lower our ratings on Hera if we lower our sovereign ratings on Italy by more than two notches, given that the company's exposure to country risk in Italy is "high".

Upside scenario

In our view, a positive rating action could occur if Hera's financial risk profile strengthens beyond our expectations. A sustainable adjusted FFO-to-debt ratio of about 23% is commensurate with a higher rating for Hera, assuming no further change in the rating on Italy or in our assessment of Hera's business risk.

Standard & Poor's Base-Case Scenario

Assumptions

- Full consolidation of Amga Udine into 2014 credit metrics.
- Capex of €1.2 billion over 2014-2016, including resources to retender existing gas concessions.
- Slightly diminishing tax rate in 2014 (41%, down from 42.8% in 2013).
- An average of €130 million disbursed for dividend payments annually.
- Average debt cost of 4.3%-4.4%.

Key Metrics

	2012a	2013a	2014e	2015e	2016e
EBITDA margin (%)	14.0	16.3	16.4	16.6	16.7
Debt/EBITDA (x)	4.1	4.1	3.8	3.7	3.5
FFO/debt (%)	15.8	16.5	16.6	18.0	19.6

FFO--Funds from operations. a--Actual. e--Estimate.

Business Risk: Strong

Hera's "strong" business risk profile takes into account the company's diversified portfolio of utility businesses in one of Italy's wealthiest regions, its supportive customer service department, and the group's dominant local market position. The company operates stable and regulated businesses (water, waste collection, electricity, and gas distribution) under long-term concessions that are remunerated based on tariff frameworks. These activities generate slightly over 50% of Hera's EBITDA and could increase their contribution over 2014-2017 depending on the outcome of the gas

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distribution retendering process, which we expect to start in the second half of 2014.

Hera's strong business risk has weakened over time owing to the company's exposure to the country risk in Italy. Relative to European peers, particularly Austrian multi-utilities, Hera faces materially higher tax pressure and potentially higher funding costs. These are linked to the need to remunerate the country risk premium to a foreign investor. Although the market's perception of the Italian risk has come down materially over the last 12 months, we believe that Hera, as well as other Italian issuers, remains vulnerable to the market's volatile perception of sovereign risk.

We believe that Hera remains exposed to the challenging economic conditions in Italy, as evidenced by the underperformance of its environmental services segment during the recession. We anticipate a mild economic recovery leading to a very moderate growth in the demand for power and gas over 2014-2015 (at about 1%). We continue to think that pressure to reduce power and gas prices remains high in Italy, which in our view could negatively affect Hera's margins in its supply segment.

That said, Hera's capacity to post ongoing growth in a challenging economic environment continues to support the "strong" business risk, in our view. Provided its acquisitive strategy continues to be implemented through share swaps, and does not impede the gradual recovery of credit metrics, we view Hera's proven skills in integrating new business and extracting cost synergies while increasing market share in businesses which we consider increasingly competitive, such as the waste treatment, power and gas supply, as supportive of the business risk. While we believe that working capital management remains an issue for the majority of our Italian utilities, which we ascribed to a relatively weak payment culture in Italy compared to European standards, we believe that Hera's increasingly prudent management helps to mitigate counterparty risk.

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 Italian default scenario. We believe that its ability to service and repay debt is superior to that of the Italian government.

Financial Risk: Significant

Our assessment of Hera's financial risk profile as "significant" reflects its aggressive dividend policy, combined with its relatively weak credit metrics, namely adjusted FFO to debt of 16.5% and debt to EBITDA of 4.1x at year-end 2013. Hera's strategy is to improve its credit metrics by growing operating cash flows over the medium term.

In our base-case scenario, however, we forecast that Hera will post neutral cash flow after capex 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, partially mitigate these risks, in our view.

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Liquidity: Strong

Our assessment of Hera's liquidity is "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 at midyear 2013, and our expectation of FFO above 1.5x in the following 12 months.

Principal Liquidity Sources	Principal Liquidity Uses
• Access to unrestricted cash of more than €900 million; • Available undrawn committed credit lines of €450 million on December 2014, which we expect will be rolled over; and • Our forecast that Hera will generate adjusted FFO of more than €500 million in the next 12 months.	• €330 million of capex; • Dividend outflows of approximately €130 million; and • Debt maturities of €340 million.

Other Modifiers

The modifiers have no impact on the rating

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)
- **Liquidity:** Strong (no impact)
- **Financial policy:** Neutral (no impact)

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- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology, Nov. 19, 2013
- Methodology: Industry Risk, Nov. 19, 2013
- Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, 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-

Additional Contact:
Infrastructure Finance Ratings Europe; InfrastructureEurope@standardandpoors.com

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