

Research Update:

# Italian Multi-Utility Hera SpA 'BBB/A-2' Ratings Affirmed; Outlook Positive

June 14, 2019

## Rating Action Overview

- Hera SpA's 2018 operating performance was better than expected, with reported EBITDA of €1,031 million and net debt almost stable year on year at €2,586 million, mainly thanks to strong performance in the networks business and cost efficiencies.
- The company aims to improve the quality of its earnings as part of its 2018-2022 business plan, with €2.2 billion of capital expenditure dedicated to fully regulated activities.
- We are affirming our 'BBB/A-2' issuer credit ratings on Hera.
- The positive outlook reflects our expectation that Hera will successfully execute its strategy, which should lead to adjusted funds from operations to debt sustainably above 23% in the next 12-18 months.

## Rating Action Rationale

The affirmation follows the company's strong operating and financial performance in 2018. In particular, reported EBITDA increased to €1,031 million, up from €985 million in 2017, with strong performance in regulated activities coupled with cost efficiencies. As a result, adjusted funds from operations (FFO) to debt increased to 23.6%, including income from last-resort clients, up from 23.0% in 2017. The income from last-resort clients had an effect of about 80 basis points on adjusted FFO to debt in 2018. This income is derived from interest on delayed payments from public administration authorities in Italy.

Hera's business risk profile benefits from the significant (about 45% of 2018 EBITDA) contribution from fully regulated water, gas, and power distribution activities. We expect fully regulated activities will increase to 55% of total EBITDA at the end of Hera's 2018-2022 business plan. This is because the company has said €2.2 billion of the €3.12 billion capital expenditure (capex) in the business plan will be dedicated to fully regulated activities. In addition, expected regulatory changes should positively affect the waste collection business (7% of EBITDA in 2018) in 2020 under the current schedule of the Italian regulator ARERA. About 28% of EBITDA comes from stable waste treatment activities, focused in northern Italy. More volatile earnings come from energy, including retail power and gas supply activities, which accounts for 17% of EBITDA, and

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other services, including public lighting and telecommunication, which account for 3%.

Hera's financial profile is supported by the group's stable cash flow generation, with about 50% of profits coming from fully regulated activities. Under the 2018-2022 business plan, Hera is increasing its capex by 9% compared with the previous 2017-2021 plan, to €3.1 billion. This, combined with a stable cash dividend of €150 million-€160 million over 2019-2021 (based on a 55%-60% pay-out ratio), working capital outflows related to the growth strategy, and delayed payments from clients, would lead to negative free cash flow in the same period. Therefore, we expect adjusted FFO to debt will slightly weaken compared with the 23.6%, including income from last-resort clients, in 2018.

## **Outlook**

The positive outlook indicates the possibility of an upgrade in the next 12-18 months if EBITDA keeps strengthening and profitability remains stable, fostered by increasing investments in regulated or quasi-regulated activities and disciplined dividend and acquisition policies. This should lead to a sustained improvement in credit metrics, notably adjusted FFO to debt of above 23% in our forecast period.

In our base case we are not assuming sizable debt-funded acquisitions, which could lead us to reassess the company's creditworthiness.

## **Downside scenario**

We could revise the outlook to stable over the next 12-18 months if Hera's FFO to debt (including income from last-resort clients) stabilizes below 23%. This could happen if:

- Hera undertook larger cash acquisitions or increased its dividend, deviating from what we would view as a 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 would also revise Hera's outlook to stable if we lower our unsolicited rating on Italy to 'BBB-' from the current 'BBB', because we cap our rating on Hera at one notch above the sovereign rating.

## **Upside scenario**

We could raise the rating 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 toward €1.1 billion by 2020, while FFO to debt (including income from last-resort clients) stays above 23% for a prolonged period.

An upgrade would also depend on Hera adhering to a prudent financial policy and our unsolicited rating on Italy remaining at 'BBB'.

## **Company Description**

Bologna-headquartered Hera is one of Italy's largest multi-utilities. Its operations include:

- Gas (28% of 2018 EBITDA), including distribution, sales, district heating, and heat management.
- Electricity (20%), including distribution, sales, and co-generation.
- Waste (25%), including the entire waste cycle (waste collection, treatment, recovery, and disposal).
- Water (25%), including integrated water cycle (aqueducts, purification, and sewerage).
- Other services (2%), including public lighting, telecoms, and minor services.

The group has over 8,670 employees, and serves about 4.4 million customers in over 350 municipalities across five regions in northern and central Italy (Emilia-Romagna, Friuli-Venezia Giulia, Marche, Tuscany, and Veneto). Hera's shareholding structure includes 111 municipalities in the reference territory, which together with other public shareholders hold approximately 47.9% of the share capital. The shareholder base is characterized by the presence of numerous municipalities, with a relatively low concentration of shares and a widespread private shareholding. About 52.1% is free float.

In 2018, Hera reported €6,626 million of revenue and €1,031 million of EBITDA.

## **Our Base-Case Scenario**

In our base case for 2019-2021, we assume:

- GDP growth has only a limited effect on Hera, as a large share of its revenue is derived from long-term contracted or regulated activities.
- Revenue increases by 1.0% per year.
- Reported EBITDA improves by a compound annual growth rate of about 3.5% to about €1.1 billion by 2021, up from €985 million in 2017 and €1.0 billion in 2018.
- A stable reported EBITDA margin of about 19%.
- Cash taxes of €160 million-€170 million.
- Negative changes in working capital by €100 million on average.
- Annual capex of €650 million on average, up from close to €500 million in 2018 and €440 million in 2017.
- Cash dividends of €150 million-€160 million, based on a 55%-60% payout ratio. Any changes in the dividend policy would weigh on the ratings.
- Net reported debt of €2.9 billion-€3.1 billion.

Based on these assumptions, we arrive at the following credit measures:

- Debt to EBITDA below 3.5x.
- FFO to debt slightly above or close to 23% (including income from last-resort clients) from 2019.

- Negative free cash flow after capex and dividends.

## **Liquidity**

We consider Hera's liquidity strong. 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 Dec. 31, 2018, 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 Dec. 31, 2018, include:

- Our estimate of about €535 million of cash and liquid investments fully available for use;
- Available undrawn committed credit lines of €550 million maturing beyond 12 months, reducing to about €500 million over the following 12 months; and
- More than €750 million of forecast cash FFO over the next 12 months.

Principal liquidity uses, as of the same date, include:

- Debt maturities of about €525 million in 2019 and about €50 million in 2020;
- Capex of more than €550 million in 2019; and
- More than €155 million paid in dividends, including minorities.

## **Environmental, Social, And Governance**

In our credit analysis of Hera, there are no relevant factors from an environmental, social, or governance standpoint.

We note Hera was the first company in Italy to issue a green bond, in June 2014, and it has almost zero exposure to generation.

About 20% of Hera's 2018 EBITDA came from regulated water distribution activities. In Italy, Mr. Federica Daga, member of the Italian lower chamber, has presented a law to make water public. We understand this could imply the loss of the water distribution concessions for Hera. Although we understand this law is not likely to be approved, we expect Hera to be adequately compensated should it lose its water concessions in favor of a public entity.

## **Issue Ratings - Subordination Risk Analysis**

### **Capital structure**

At year-end 2018, Hera's capital structure comprised about €3.3 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.

## **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 (Medial volatility table)

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

## **Related Criteria**

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- 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

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- 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
- 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

- Italian Multi-Utility A2A SpA 'BBB/A-2' Ratings Affirmed; Outlook Stable, May 28, 2019
- Why We See Italy's Water Regulatory Framework As Supportive, May 16, 2018
- Italian Multi-Utility Hera Outlook Revised To Positive On Stronger Credit Metrics; 'BBB/A-2' Ratings Affirmed, March 13, 2018
- Why We See Italy's Electricity And Gas Regulatory Frameworks As Supportive, Nov. 30, 2017

## Ratings List

### Ratings Affirmed

#### Hera SpA

|                      |                  |
|----------------------|------------------|
| Issuer Credit Rating | BBB/Positive/A-2 |
|----------------------|------------------|

|                  |     |
|------------------|-----|
| Senior Unsecured | BBB |
|------------------|-----|

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