Terna - Rete Elettrica Nazionale SpA Italian Republic, Utilities

SCOPE A- STABLE

Corporate profile

Terna - Rete Elettrica Nazionale SpA (Terna SpA) is the Rome-based owner and operator of the Italian electricity transmission grid (transmission system operator or TSO). With 72,900 kilometres of power lines, Terna covers around 99% of Italy's extra-high and high-voltage electricity grid, which makes it one of the largest independent TSOs in Europe. Terna also operates interconnectors to neighbouring countries and offers technical support to other TSOs, mainly in emerging markets.

Key metrics

			Scope estimates		
Scope credit ratios	2017	2018	2019E	2020E	2021E
EBITDA/interest cover (x)	>10	>10	>10	>10	>10
Scope-adjusted debt (SaD)/EBITDA (x)	4.9	4.8	4.9	5.0	5.3
Free operating cash flow (FOCF)/SaD (%)	10	4	2	3	-2
Liquidity (%)	>200	>200	>200	>200	>200

Rating rationale

Scope Ratings has today assigned a first-time issuer rating of A-/Stable/S-1 to Terna - Rete Elettrica Nazionale S.p.A. (Terna SpA). Senior unsecured debt issued by Terna SpA is rated A-.

The issuer rating reflects our view of the company's limited business risk due to its monopolistic position in Italy under a robust regulatory framework, which guarantees timely cost recovery and robust operating cash flow. However, this is offset by structural aspects of the company's core service territory, the Italian Republic (rated BBB+/Stable at Scope). The rating is also constrained by the financial risk profile, which is characterised by high indebtedness and strong capex requirements over the next few years.

Outlook

The Stable Outlook reflects our expectation that Terna's indebtedness will remain high, owing to rising capex needs over the mid-term as indicated by the updated strategic plan. In this regard, we estimate a Scope-adjusted leverage (SaD/EBITDA) sustained at around 5x in the next few years.

A positive rating action rating could be warranted if the company strengthened its balance sheet, e.g. by a SaD/EBITDA moving towards 4x on a sustainable basis. Given the large investment programme and low free operating and discretionary cash flows over the next few years, such a rating upgrade is not likely for the time being.

A negative rating action could result from a deterioration of the financial risk profile from SaD/EBITDA rising towards 6x, which is also deemed as unlikely. This could be due to a prolonged period of negative free operating and discretionary cash flows or a drastic, adverse change in the Italian tariff regulation which jeopardises Terna's high margins and timely recovery of costs.

Ratings & Outlook

Corporate rating	A-/Stable
Short-term rating	S-1
Senior unsecured rating	A-

Analysts

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Related methodology/research

Corporate Rating Methodology

Rating Methodology: European Utilities

Energy transition a boon for green bonds, Mar 2019

European utilities outlook 2019: Political, regulatory risks move centre stage, Dec 2018

Scope's sovereign rating on the Italian Republic

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Rating drivers

Positive rating drivers	Negative rating drivers
Strong business risk profile characterised by: • Monopolistic position in Italy • Over 90% of revenues protected by a reliable regulatory framework until 2023, resulting in the strong stability and visibility of cash flows • Large virtual outreach with more than 60m customers • Very high profitability (recurring EBITDA margin of above 70%) related to a favourable tariff-setting environment and large share of regulated asset base (RAB) remuneration • Full cost coverage backed by reliable regulatory framework in Italy until 2023 High leverage partly offset by sustainably strong interest coverage and robust liquidity Strong access to capital funding and extensive implementation of ESG	Persistent weaknesses in financial risk profile including a Scope-adjusted leverage of around 5x Growing pressure on FOCF generation going forward from enlarged investment programme Structural aspects of the service territory in the Italian Republic (BBB+/Stable by Scope)

Rating-change drivers

Positive rating-change drivers	Negative rating-change drivers
Improvement of leverage (SaD/EBITDA) towards 4x. However, this is deemed unlikely in light of the company's updated investment plan	Leverage rising toward 6x as a result of a prolonged period of negative free operating and discretionary cash flows, albeit deemed as unlikely for the time being or drastic, adverse changes in the Italian tariff regulation

Financial overview

			Scope estimates	
Scope credit ratios	**2017**	**2018**	**2019E**	**2020E**
EBITDA/interest cover (x)	>10	>10	>10	>10
SaD/EBITDA (x)	4.9	4.8	4.9	5.0
FOCF/SaD (%)	10	4	2	3
Scope-adjusted EBITDA in EUR m	**2017**	**2018**	**2019E**	**2020E**
EBITDA	1,604	1,651	1,690	1,727
Operating lease payments in respective year	13	17	17	17
Scope-adjusted EBITDA	**1,617**	**1,668**	**1,707**	**1,744**
Scope-adjusted interest in EUR m	**2017**	**2018**	**2019E**	**2020E**
Net interest	94	97	122	127
Interest component operating leases (estimated)	3	3	3	3
Scope-adjusted interest	**97**	**100**	**125**	**130**
Scope-adjusted debt in EUR m	**2017**	**2018**	**2019E**	**2020E**
Reported gross financial debt	9,684	9,542	9,287	10,180
deduct: cash, cash equivalents	1,989	1,733	1,121	1,722
add: cash not accessible	-	-	-	-
add: pension adjustment	81	69	69	69
add: operating lease obligations (estimated NPV)	57	61	61	61
Scope-adjusted debt	**7,833**	**7,939**	**8,296**	**8,588**

Business risk profile

Natural monopoly in a huge service territory

Terna's creditworthiness is strongly supported by its low overall business risks, reflected in our assessment of the grid operator's **business risk profile at AA-**. This is due to the company's natural monopoly in the Italian Republic and the supportive regulatory framework in Italy.

Concession until 2030 … and a very high likelihood of its retention thereafter

Terna is Italy's TSO, a position granted by the Ministry of Productive Activities in 2005 giving Terna the exclusive right to provide the country's electricity transmission and dispatching until 2030. We deem it very likely that the TSO will keep its concession thereafter. This view is based on Terna's operational efficiency, with 99.99% average service availability and insignificant grid losses; proximity to the Italian government through CDP Reti; and ownership of more than 99% of Italy's electricity transmission grid (circuit length of over 70,000 km), creating a lack of real alternative.

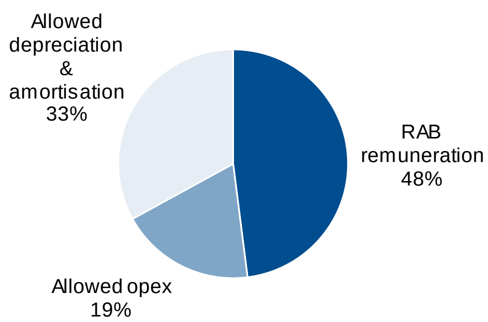
Regulatory framework ensures timely cost recovery

A clear credit-positive is the regulatory framework for tariff setting in the transmission, distribution, measurement and dispatching of electricity by Italy's Regulatory Authority for Energy, Networks and the Environment (ARERA). Firstly, the tariff setting which is based on a 'cost plus approach' has been proven as robust and reliable, currently being in the 5th regulatory period, lasting from 2016 to 2023, ensures the full cost coverage of direct operating and indirect capital costs in a timely manner through regulated feed-through tariffs. Secondly, Italy's tariff mechanism is predominantly based on load, rather than on consumption, which improves the visibility of cash flows and its robustness against fluctuations in electricity demand.

Favourable regulation expected to continue

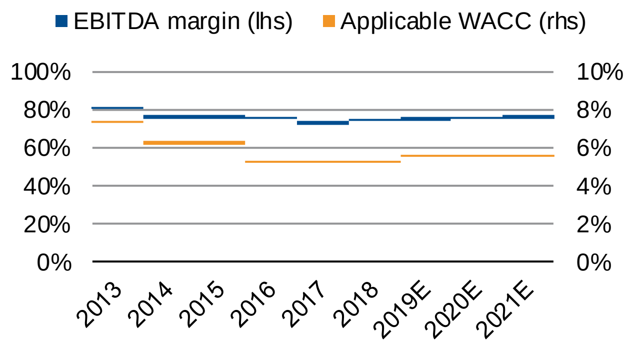
While the current regulatory period (until 2023) provides good medium-term visibility, we deem it unlikely that future regulation will lead to disadvantageous tariff regimes. This is due to: i) the track record of Italy regulator over the last years of not making drastic changes to its general regulatory approach or the applicable weighted cost of capital (WACC); and ii) the regulator's gradual introduction of incentives based on an output mechanism which will likely provide an opportunity to benefit from achieved cost savings.

Figure 1: Cost components in regulated tariffs, 2019



Source: Terna, Scope

Figure 2: EBITDA margin and applicable WACC on regulated asset base



Source: Terna, ARERA, Scope

Increasing importance of dispatching and interconnectors

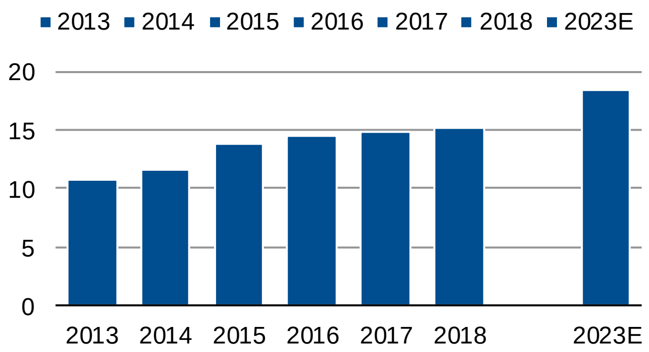
Terna's very strong market position as the operator of electricity flows will become even more important over the next few years due to:

- ongoing structural changes in the merit order with a steadily growing share of feed-in from renewable energy sources – expected to rise from around 40% in 2018 (37% in 2017) to 60% by 2030 according to Italy's National Integrated Plan for Climate and Energy 2030 – and a gradual phase-out of thermal generation capacities in Italy, and
- the chronic shortage of energy generation in Italy, increasing importance of interconnectors with neighbouring countries.

Very high profitability in the context of European TSOs

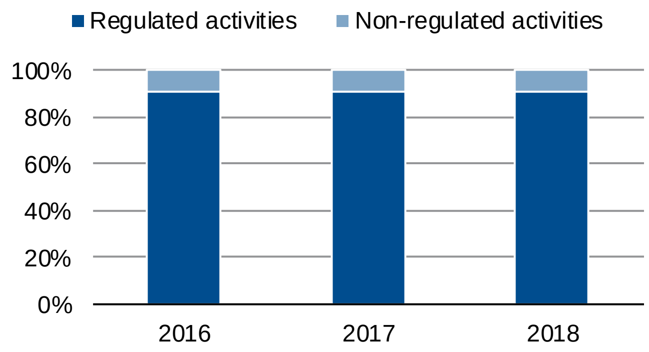
We highlight the company's very strong margin profile, as measured by an EBITDA margin of consistently above 70%, one of the highest among European TSOs. This is strongly linked to the large share of implicit costs related to the remuneration of Terna's regulated asset base in its tariff structure (see figure 1). The consistently high margin underscores the TSO's protected market position and supportive regulatory framework. We believe these levels will continue for the next few years and then gradually improve until 2023, based on the most recent increase of the WACC (5.3% to 5.6%) for the 2019-21 regulatory sub-period, in conjunction with the steady growth of the regulated asset base (see figure 3), and the introduction of output-based incentives.

Figure 3: Development of regulated asset base (EUR bn)



Source: Terna, Scope

Figure 4: Revenue split for different grid services



Source: Terna, Scope

Virtual outreach to more than 60m end-customers

Given Terna's monopolistic position, its credit strength does not rely on diversifying into other utility segments or markets. The company's virtual outreach extends to more than 60m residential, commercial and industrial users of the transmission grid. Moreover, around 10% of Terna's revenues stems from activities linked to international and cross-border activities respectively, such as interconnectors, a source which should gain further importance with the completion of the Italy-France interconnector and MONITA subsea interconnector between the Italy and Montenegro, and the activities under the roof of Terna Plus (see figure 4).

Exposure to Italy a primary credit weakness

While we do not apply any mechanistic cap to corporate ratings with regards to sovereign risks and the respective sovereign rating, we reflect the structural aspects of the major service territory within the business risks, particularly in the context of a comparison to TSO peers operating in countries with stronger fundamentals.

We view Terna's service territory, the Italian Republic, rated BBB+/Stable by Scope, as a weakness for its business risk profile, due to expected economic volatility despite the country's credit strengths. As pointed out by Scope's Public Finance team Italy's creditworthiness is largely bolstered by i) its euro area membership with a strong reserve currency and an independent European Central Bank effectively acting as a lender of last resort and its systemic financial importance; and ii) a significant track record of primary surpluses in past decades and domestic constitutional fiscal frameworks, enhanced during the debt crisis – which obliges Italy to adhere to a balanced budget – although this framework is being tested. Moreover, Italy is shielded partially from market turbulence by the relatively long 6.8-year average maturity of its debt stock, with 68% of debt (as of 2017) being held by the resident sector. However, debt sustainability is being threatened by the progressive shift towards anti-establishment groups, related implications for the longer-run economic reform agenda and expansionary fiscal programme and reversal of earlier structural reforms. This could also harm Terna's ability to continue sourcing funding at comparatively advantageous conditions.

Financial risk profile

Terna's issuer rating is somewhat constrained by the **financial risk profile (rated BBB-).**

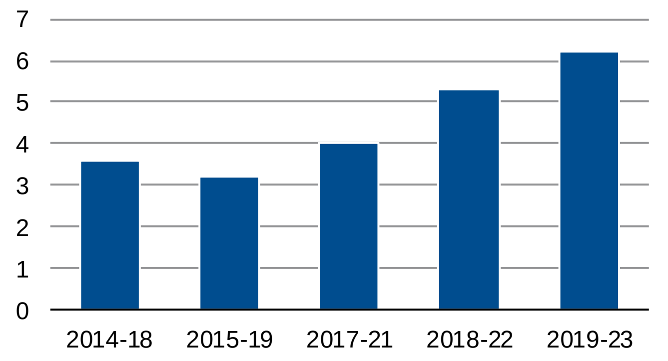
Our forecasts primarily reflect the following assumptions:

- Revenue growth based on CPI expectations and steady growth envisaged for Terna's regulated asset base following the increased capex from the 2019-23 strategic plan
- Working capital swings in line with revenue growth
- Slightly growing EBITDA margin as a function of the raised WACC and extra earnings potential from the gradual introduction of output-based incentives
- Gradually rising capex needs within the EUR 6.2bn (net) investment plan for 2019-23, which, however, is rather back-end-loaded
- Growth capex and maturing debt primarily (re)-financed through new debt issues
- Debt redemptions according to maturity schedule
- Further dividend increases over the next few years with a 2018-21 CAGR of 7.5% (which is higher than the company's guidance)

Rising capex needs expected to result in persistently high leverage

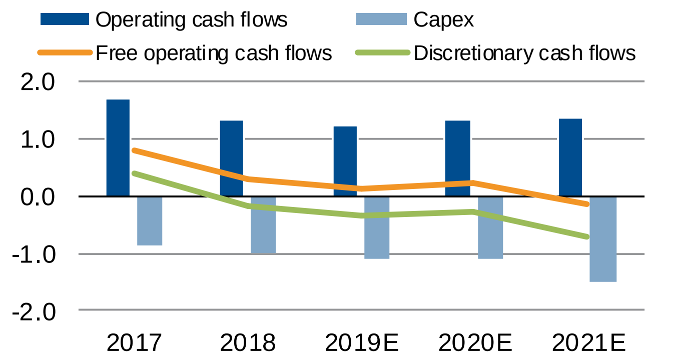
We expect Terna to maintain its financial profile over the next few years based on its new strategic plan for 2019-23 (announced in March 2019), with net capex earmarked at EUR 6.2bn over the next 5 years, of which 70% is already authorised.

Figure 5: Terna's mid-term capex plans over time (EUR bn)



Source: Terna strategic plans, Scope estimates

Figure 6: Rising capex and effect on cash flows (in EUR bn)



Source: Terna, Scope estimates

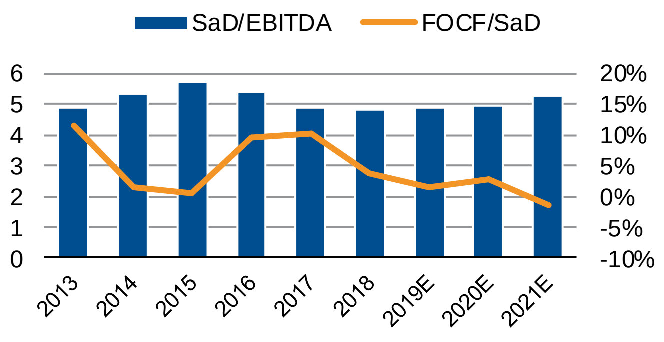
Leverage persistently around 5x

We regard Terna's leverage – as measured by a Scope-adjusted debt/EBITDA of around 5x – as comparatively high among European grid/network operators, even given that operators of monopoly-like corporate structures and operators of regulated infrastructure tend to be more indebted than non-regulated corporates. The company's updated investment programme (see figure 5) is likely to result in free operating cash flows being at breakeven in 2019 and 2020 and slightly negative in 2021, with discretionary cash flows being slightly negative. As a consequence, Terna's high indebtedness is likely to persist and is expected to increase slightly until 2021 (see figure 7).

Strong debt protection

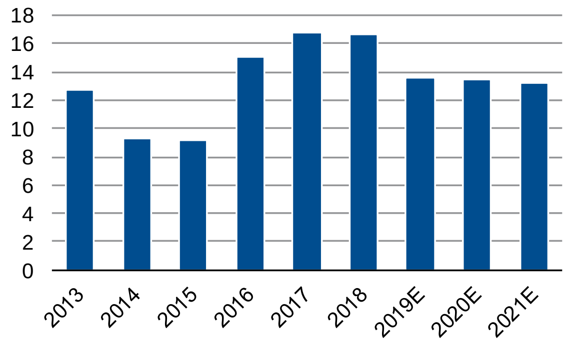
Nevertheless, we have no concerns over the prolonged investment phase. Reasons include the timely cost recovery, as we lay out in the business risk profile section, and the debt protection, as measured by a strong EBITDA interest coverage of consistently above 10x, largely supported by an average interest rate of well below 2% (after swaps) on an average debt maturity of about five years. Interest coverage is expected to remain strong, following the refinancing of two bonds (EUR 600m bond in October 2019 with a 4.88% coupon; EUR 1.25bn bond at 4.75% in March 2021) and the issuance of two green bonds in 2019 (five-year EUR 250m bond at 1% in January 2019; seven-year EUR 500m at 1% in April 2019).

Figure 7: Scope-adjusted leverage (SaD/EBITDA)



Source: Terna, Scope estimates

Figure 8: Debt protection (EBITDA/interest)



Source: Terna, Scope estimates

Sound liquidity

Terna has to refinance about EUR 2.6bn of debt over the next three years (EUR 1.2bn in 2019E, EUR 0.1bn in 2020E and EUR 1.35bn in 2021E). This is likely to happen through external funding, given our expectations of slightly negative discretionary cash flows over that period and an unrestricted cash cushion of more than EUR 1bn at YE 2018. Pointing to the company's available credit facilities of more than EUR 2.5bn at the end of April 2019, liquidity will be well above 200% over the next three years, which we deem to be sound for the low investment-grade financial risk profile.

Excellent access to funding

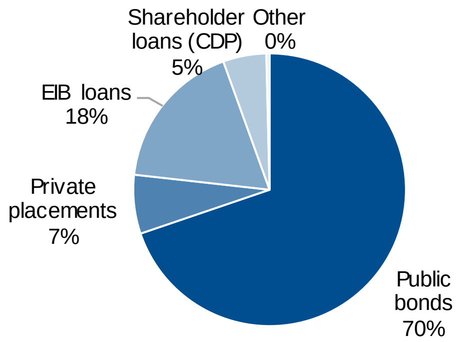
We expect no severe issues regarding external financing for growth capex and refinancing as Terna benefits from an excellent access to financing channels. Our view is based on:

- Terna's frequent issuance of both public and private debt, with an aggregate nominal value of about EUR 6.7bn under the company's EUR 8bn EMTN programme;
- Its ability to place very long-term debt with bullet maturities of 20 years, backed by its very robust business model; and
- The increasing usage of 'green financing' such as two green bonds placed in 2018 and 2019 as well as the newly arranged EUR 900m ESG-linked back-up revolving credit facility as one pillar of their credit facilities.

S-1 short-term rating

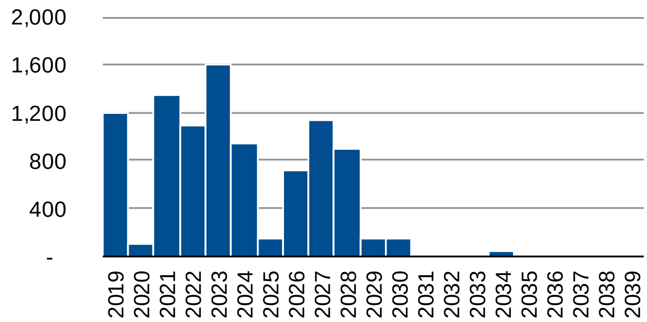
The sound liquidity and excellent access to financing justify the assigned S-1 short-term rating.

Figure 9: Financing structure at YE 2018F



Source: Terna, Scope

Figure 10: Upcoming debt maturities (EURm) at YE 2018



Source: Terna, Scope

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