Terna - Rete Elettrica Nazionale SpA Italian Republic, Utilities

A- STABLE

Corporate profile

Terna - Rete Elettrica Nazionale SpA (Terna) is the Rome-based owner and operator of the Italian electricity transmission grid (transmission system operator or TSO). With around 75,000 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	2018	2019	2020E	2021E	2022E
EBITDA/interest cover (x)	>10	>10	>10	>10	>10
Scope-adjusted debt (SaD)/EBITDA (x)	4.7	4.7	4.9	5.1	5.4
Free operating cash flow (FOCF)/SaD (%)	4	3	-2	0	-2
Liquidity (%)	>200	>200	>200	>200	>200

Rating rationale

Scope Ratings has today affirmed the A-/Stable issuer rating of Terna - Rete Elettrica Nazionale SpA (Terna). Long-term senior unsecured debt issued by Terna and its predecessor under the EMTN programme has been affirmed at A-; short-term debt has been affirmed at S-1.

Terna's issuer rating reflects its limited business risks, with a monopolistic position in Italy under a robust regulatory framework that guarantees timely and full cost recovery as well as strong operating cash flow, depicted by an EBITDA margin sustained above 70%. The company's strong operating performance amid the Covid-19 pandemic as well as depressed electricity consumption and transmission volumes impressively underpins its robustness under the regulated framework for electricity transmission.

Terna's financial risk profile is increasingly putting pressure on the rating following the envisaged acceleration of capex and resulting negative free operating and discretionary cash flows over the next few years. While still solid, the debt headroom towards a 6.0x Scope-adjusted debt (SaD)/EBITDA is shrinking. However, the deteriorating view on leverage is largely balanced by the strong liquidity and interest coverage as well as a significant likelihood of rating-supporting measures that keep leverage under control.

Outlook and rating-change drivers

The Stable Outlook reflects Scope's expectation that Terna's indebtedness will remain high, with a Scope-adjusted debt/EBITDA in the 5.0-5.5x range in the next few years, owing to rising capex needs over the medium term, as indicated by the updated strategic plan. A positive rating action rating could be warranted if the company strengthened its balance sheet, e.g. by reducing Scope-adjusted debt/EBITDA towards 4x on a sustained basis. Given the large investment programme and low free operating and discretionary cash flows over the next few years, such a rating upgrade is unlikely for the time being. A negative rating action could result from a deterioration in the company's financial risk profile. This could follow a prolonged period of negative free operating and discretionary cash flows that results in Scope-adjusted debt/EBITDA rising towards 6x, or drastic adverse changes in Italian tariff regulation that jeopardises Terna's high margin profile and timely recovery of costs.

Ratings & Outlook

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

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Related Methodologies and Rating Updates

Corporate Rating Methodology

Rating Methodology: European Utilities

Scope's sovereign rating on the Italian Republic

Scope affirms A-/Stable issuer rating of Italy's TSO Terna SpA, Mar 2020

Scope assigns A-/Stable/S-1 issuer rating to Italy's Terna SpA, May 2019

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Rating drivers

Positive rating drivers	Negative rating drivers
Strong business risk profile characterised by: • Monopolistic position in Italy and strong business resilience in times of economic turmoil • Over 90% of revenues protected by a reliable regulatory framework until 2023, resulting in strong stability and visibility of cash flows • Large virtual outreach with more than 60m customers and more than 35m connection points • Very high profitability (recurring EBITDA margin of above 70%) related to a favourable tariff-setting environment and large share of regulated asset base remuneration • Major part of long-term investment plan facilitating Italy's energy transition (ESG factor) High leverage partly offset by sustainably strong interest coverage and robust liquidity Financial policy aimed at retaining strong standalone rating with rating boundaries Strong access to capital funding and extensive implementation of ESG	Persistent weaknesses in financial risk profile including a Scope-adjusted leverage of 5-5.5x over the next few years Growing pressure on free operating cash flow going forward from enlarged investment programme Structural aspects of the service territory in the Italian Republic (BBB+/Negative by Scope)

Rating-change drivers

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

Financial overview

			Scope estimates		
Scope credit ratios	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA/interest cover (x)	>10	>10	>10	>10	>10
SaD/EBITDA (x)	4.7	4.7	4.9	5.1	5.4
Free operating cash flow/SaD (%)	4	3	-2	0	-2
Liquidity (%)	>200	>200	>200	>200	>200
Scope-adjusted EBITDA in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
EBITDA	1,651	1,741	1,796	1,851	1,882
Operating lease payments in respective year	17	-	-	-	-
Scope-adjusted EBITDA	**1,668**	**1,741**	**1,796**	**1,851**	**1,882**
Scope-adjusted interest in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Net interest	97	81	124	133	145
Interest component, operating leases (estimated)	3	-	-	-	-
Scope-adjusted interest	**100**	**81**	**124**	**133**	**145**
Scope-adjusted debt in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Reported gross financial debt	9,542	9,793	10,901	11,278	11,967
deduct: cash, cash equivalents	1,732	1,571	1,946	1,805	1,697
add: cash not accessible	-	-	-	-	-
add: pension adjustment	69	64	64	64	64
add: operating lease obligations (estimated NPV)	61	-	-	-	-
add/deduct: other adjustments (hedges)	-58	-160	-220	-176	-141
Scope-adjusted debt	**7,883**	**8,126**	**8,799**	**9,361**	**10,193**
Liquidity in EUR m	**2018**	**2019**	**2020E**	**2021E**	**2022E**
Unrestricted cash (t-1)	1,989	1,732	1,571	1,946	1,805
Free operating cash flow (t)	285	232	-218	35	-202
Committed credit lines (t-1)	2,050	2,450	2,650	2,650	2,650
Short-term debt (t-1)	**1,002**	**1,256**	**152**	**1,347**	**1,097**

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. Terna's monopoly is protected by its concession 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.

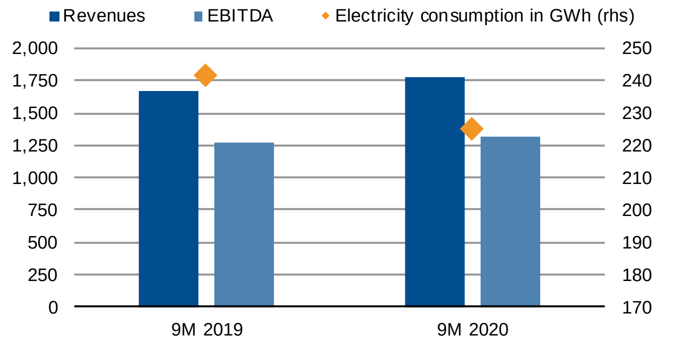
Exposure to Italy a primary credit weakness

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 comparison to TSO peers operating in countries with stronger fundamentals.

Resilience against short-term disruptions or weakening economic conditions

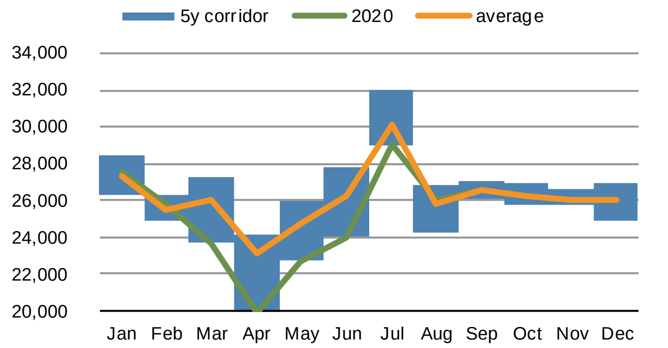
While Terna's exposure to the Italian Republic (rated BBB+/Negative by Scope) remains a credit-negative, the company's revenues and margins have been resilient, even in times of economic turmoil. The company's strong operating performance amid the Covid-19 pandemic as well as depressed electricity consumption and transmission volumes impressively underpins its robustness under the regulated framework for electricity transmission. We keep our view that, despite being subject to regulations and significant public scrutiny, Terna is affected only to a limited extent by the finances and macroeconomy of Italy (a feature shared by other regulated grid operators operating in mature and investment-grade-rated countries). Firstly, Terna's remuneration for its crucial infrastructure assets and services, in the form of regulated tariffs (more than 90% of recurring income), is largely independent of macroeconomic developments. Secondly, deteriorating sovereign refinancing rates are expected to have only a limited effect on regulated grid operators' refinancing rates and are partially offset by adjusted tariffs (through an adjusted WACC). Lastly, Scope deems it unlikely that a significant negative adjustment of electricity transmission tariffs would become politically sensitive, given the low single-digit percentage earmarked for transmission infrastructure in the electricity bills of industrial, commercial and household customers.

Figure 1: 9M operating results 2020 vs 2019 in EURm against significant drop in consumption volumes



Source: Terna, Scope

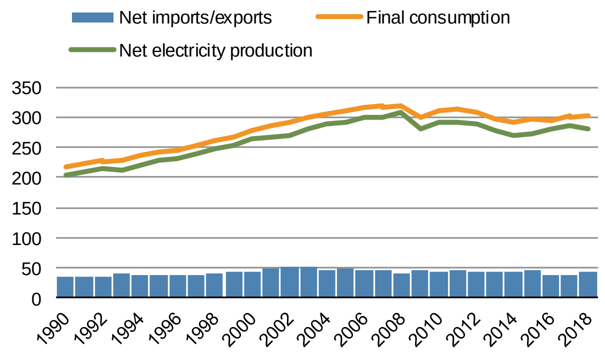
Figure 2: Italy electricity consumption, 2020 vs seven-year average (GWh)



Source: Terna, Scope

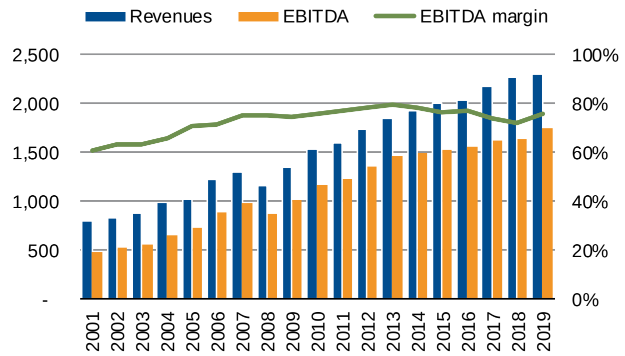
Despite sobering macroeconomic prospects in Italy, we flag that Terna proved its robustness during the 2008/09 global financial crisis and the 2011/12 euro crisis, the latter of which affected Italy strongly. Since 2000, Terna's EBITDA has reduced only once on a year-on-year basis (in 2008) and EBITDA margins have remained around or above 70%. Italy's framework for regulated grid activities is effective at limiting volume effects (only 10% of the transmission tariff relates to energy volume, while 90% relates to load, which is robust against kilowatt hours withdrawn from the transmission grid). It is also our understanding that the company can recover the revenue gap in subsequent periods, as missed revenues would be added to the cost base if actual transmission volumes are lower than forecasted. Consequently, we regard the company to be robust against temporary disruptions that could weaken short-term cash flow generation.

Figure 3: Long-term development of electricity generation and consumption in Italy (in TWh)



Source: Eurostat, Scope

Figure 4: Resilience of Terna's revenue and EBITDA development (in EUR m)

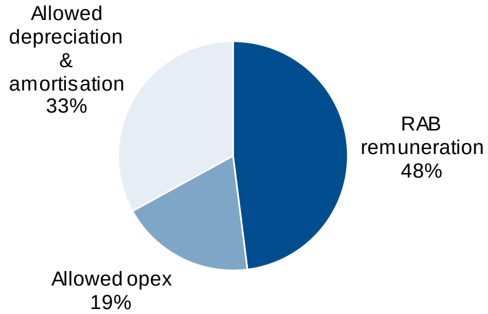


Source: Bloomberg, Scope

Favourable regulation expected to continue

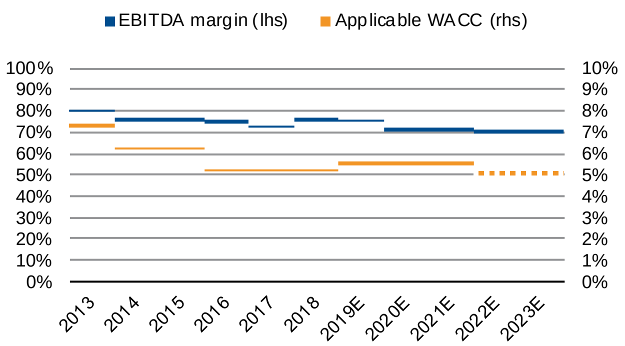
While the current regulatory period (until 2023) provides good medium-term visibility, we deem it unlikely that future regulation will lead to disadvantageous tariff regimes. This is due to: i) the track record of the Italian regulator in recent years of not making drastic changes to its general regulatory approach or the applicable 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. Ultimately, our view is supported by the importance of transmission infrastructure for Italy's ongoing energy transition. We highlight the high proportion of scheduled capex over the next few years relating to investments, which will ensure a smooth expansion of renewable energy in the country but also improve the integration among Italy's main islands and with neighbouring countries. Overall, we regard Terna's business to benefit from political and regulatory tailwinds that reduce the likelihood of unexpected adverse changes in regulation (ESG-factor: credit-positive environmental and social factor).

Figure 5: Cost components in regulated tariffs, 2020E



Source: Terna, Scope

Figure 6: EBITDA margin and applicable WACC on regulated asset base



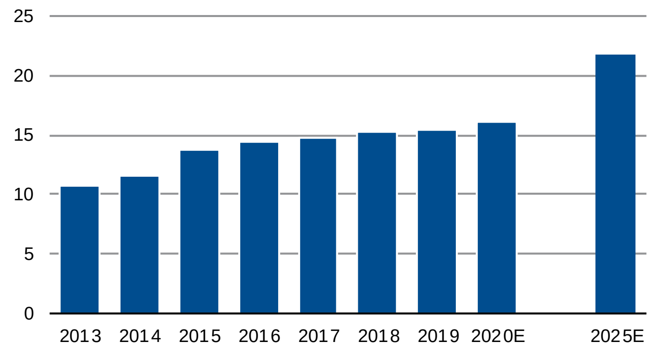
2022/23 WACC not yet fixed by regulator

Source: Terna, ARERA, Scope

Very high profitability in the context of European TSOs

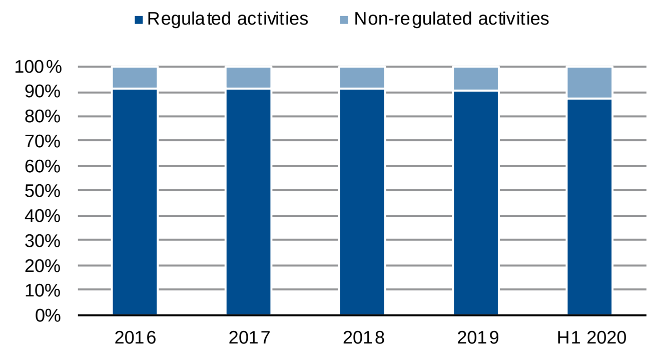
We maintain our assumptions on the company's very strong margin profile, as measured by an EBITDA margin of consistently above 70%, one of the highest among European TSOs. This is strongly linked to the large share of regulated businesses, which make up more than 90% of revenues. The high margin for such regulated activities is strongly linked to the large share of implicit costs related to the remuneration of Terna's regulated asset base in its tariff structure. Given the fixed WACC during the current sub-period (2020-21) of the fifth regulatory period, group profitability is expected to be consistently above 70%. The highest risks for profitability and cash flow generation is an adverse regulatory change leading to decreased tariffs. However, we believe the regulatory framework and applicable WACC are unlikely to see major changes for the remaining two years of the fifth regulatory period (2022 and 2023). While it can be argued that the regulator could compromise transmission tariffs to appease politicians and the public, this is unlikely given the importance of Terna's transmission infrastructure for Italy's ongoing energy transition as well as current developments regarding applicable risk premiums for investments in Italy.

Figure 7: Development of regulated asset base (EUR bn)



Source: Terna, Scope

Figure 8: Revenue split for different grid services



Source: Terna, Scope

Virtual outreach to more than 60m end-customers and more than 35m connection points

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 35m connection points, representing 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 like interconnectors as well as the activities under the roof of Terna Plus.

Financial risk profile

No change in rating case following strategy update

Terna's issuer rating remains somewhat constrained by its **financial risk profile (assessed BBB-).** We believe that the company's financial figures will remain within the rating case despite challenges in Italy and the accelerated capex needs as displayed by the updated five-year investment plan until 2025.

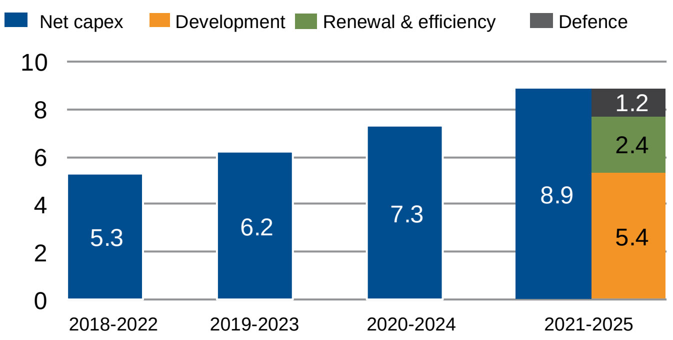
Our forecasts primarily reflect the following assumptions:

- Revenue growth based on CPI expectations and steady growth envisaged for Terna's regulated asset base following increased capex from the 2021-25 strategic plan
- Working capital swings in line with revenue growth
- Stable EBITDA margin as a function of the constant WACC for 2020/21; EBITDA margin for 2022/23 (last two years of the fifth regulatory period) expected to remain slightly above 70% as an expected reduction of the applicable WACC is balanced through the rising regulatory asset base and output-based incentives
- Gradually rising capex needs within the EUR 8.9bn (net) investment plan for 2021-25, 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 in line with the company's guidance

Rising capex needs expected to result in gradually increasing leverage

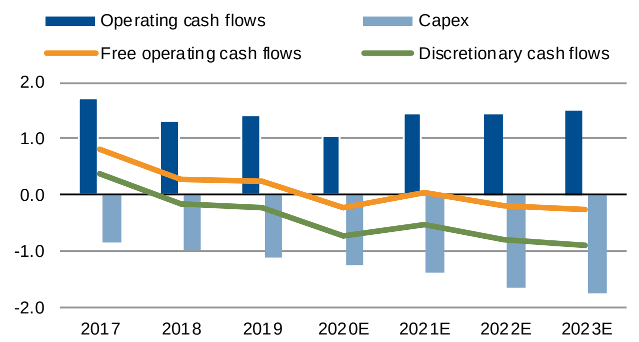
Reflecting Terna's updated strategic plan for 2021-25 (announced in November 2020), with net capex earmarked at EUR 8.9bn, we expect Terna to maintain its financial profile, though with a gradual reduction of its headroom towards our negative rating trigger for debt. This is the consequence of accelerated capex that cannot be fully covered by operating cash flows. Assuming the company keeps its ambition to gradually increase shareholder remuneration through dividends, the resulting negative discretionary cash flows will increasingly burden indebtedness.

Figure 9: Terna's mid-term capex plans over time (EUR bn)



Source: Terna strategic plans, Scope

Figure 10: Rising capex and effect on cash flows (in EUR bn)



Source: Terna, Scope estimates

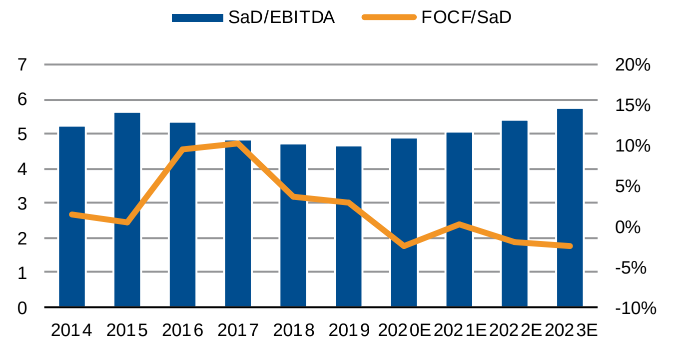
Leverage gradually rising towards 5.5x

The resulting negative free operating and discretionary cash flow will leave little room for Terna to keep its leverage – as measured by Scope-adjusted debt/EBITDA – below 5.0x, as it has over the last four years. While Scope forecasts leverage to increase gradually to around 5.5x over the next two years, Terna's headroom to a 6x Scope-adjusted debt/EBITDA, which is the trigger for a potential negative rating action, remains significant. However, with capex increasing in the latter stage of the new plan, such headroom would shrink materially after 2022 if Terna does not offset the effects. However, Scope understands that if the debt headroom were to become too narrow, the company would commit to measures such as (re)financing through hybrid debt and other measures that would strengthen the company's balance sheet. Based on Scope's EBITDA forecasts for the next three years Scope assumes that Terna's debt headroom against a potential negative rating action would shrink from EUR 1.7bn in 2021 to around EUR 500m in 2023.

Strong debt protection

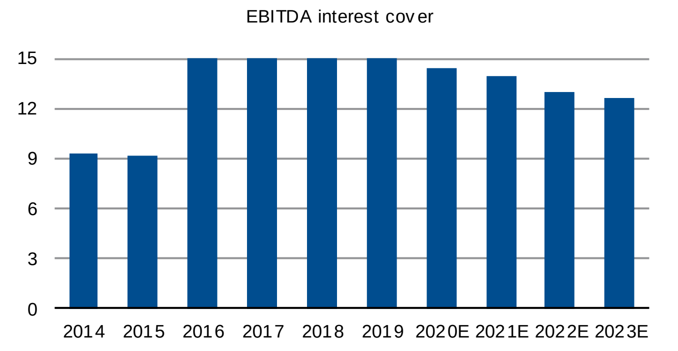
Debt protection – measured by the EBITDA interest coverage ratio – remains well above 10x, despite the increased debt burden. Amid the still favourable interest level, Scope expects significant interest savings following the refinancing in March 2021 of the EUR 1.25m bond with a 4.75% coupon. Terna's favourable interest rate level was impressively evidenced in 2020 by two debt placements: a 12-year green bond with a 0.75% coupon issued in July and a 10-year bond with a 0.375% coupon in September.

Figure 11: Scope-adjusted leverage (SaD/EBITDA)



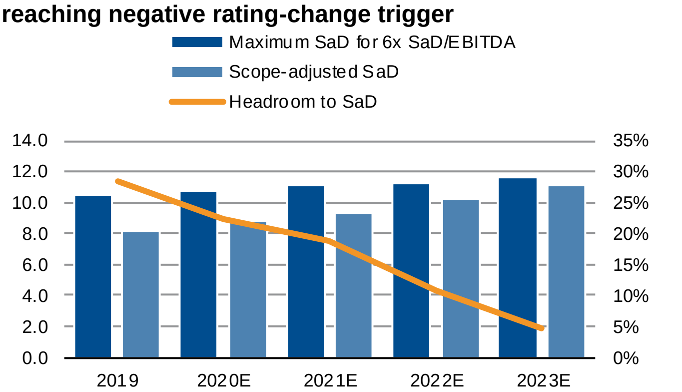
Source: Terna, Scope estimates

Figure 12: Debt protection (EBITDA/interest)



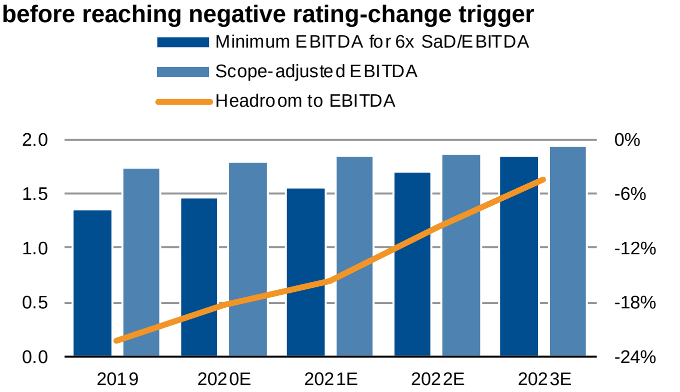
Source: Terna, Scope estimates

Figure 13: Significant headroom on SaD (EUR bn) before reaching negative rating-change trigger



Source: Scope estimates

Figure 14: Significant headroom on EBITDA (EUR bn) before reaching negative rating-change trigger



Source: Scope estimates

Sound liquidity

Terna's liquidity position is expected to stand strong despite the accelerated capex plan and the more than EUR 4.0bn of debt to be refinanced over the next three years (EUR 1.4bn in 2021E, EUR 1.1bn in 2022E and EUR 1.6bn in 2023E). While Terna is likely to refinance maturing bonds via capital markets, its annual refinancing needs are consistently covered twice over, by the unrestricted cash buffer, expected to remain above EUR 1.5bn (EUR 3bn as of September 2020), and available credit facilities, expected at more than EUR 2.5bn at YE 2020. As such, Terna's strong liquidity somewhat balances out Scope's slightly deteriorated view on leverage and free cash flows.

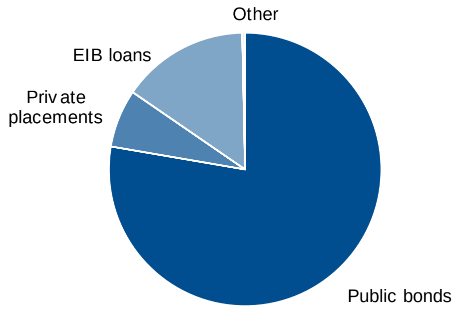
Excellent access to funding

We expect no severe issues regarding external financing for growth capex and refinancing as Terna benefits from excellent access to financing channels thanks to its monopolistic position and recoverable, unencumbered asset base. Our view is based on:

- Terna's frequent issuance of both public and private debt under its EUR 8bn EMTN programme;

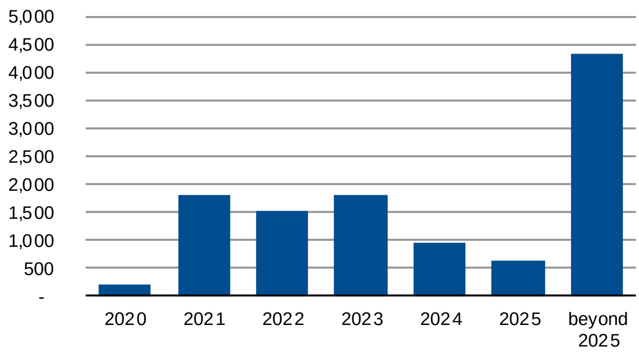
- Its ability to place very long-term debt, backed by its very robust business model; and
- The increasing usage of 'green financing', such as the three green bonds placed during 2018-20 as well as EUR 2.65bn ESG-linked back-up revolving credit facility, set up as a pillar of the company's credit facilities.

Figure 15: Financing structure at YE 2020E



Source: Terna, Scope

Figure 16: Upcoming debt maturities (EUR m) as of Sep 2020



Source: Terna, Scope

Long-term and short-term debt ratings

Senior unsecured debt rated at the level of the issuer

All senior unsecured debt issued under Terna's EMTN programme has been affirmed A-, at the level of the issuer rating.

S-1 short-term rating

Terna's S-1 short-term debt rating has been affirmed, bolstered by its sound and sustained liquidity measures as well as its well-diversified funding channels consisting of capital market debt and loan financing (i.e. EIB and shareholder loans as well as ESG credit facilities).

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