

## Company

27 July 2009 | 8 pages

# TERNA SpA (TRN.MI)

 Equity 

## 1H09 Preview

- Volumes likely down but little impact** — Volumes of electricity should be down by 7.7% due to the impact of recession, but this should have little impact on Terna, as current regulation insulates Terna from adverse movements of transported volumes this year.
- Change in consolidation perimeter** — Starting from this semester Terna should report Brazilian assets as below the EBIT line as the sale of these has already been agreed, hence operational profits reflect just Italian activities.
- Profits down on an un-adjusted basis** — We expect EBITDA down 5.3% at €454m and EBIT down 6.8% to €324m. Also in 1H09 Terna will not benefit from exceptional items reported last year that had positive impact on net profits; the latter should come in at €176m, 13.9% below last year.
- Conference call** — Results will be announced on 28 July; conference call at 5pm CET (+39 02 303509003). We do not anticipate a major surprise with the results or the conference call, but further explanations as to how the proceeds from the sale of the Brazilian assets could affect the dividend policy could help the shares in the short term, in our view.

|                              |              |
|------------------------------|--------------|
| <b>Buy/Medium Risk</b>       | <b>1M</b>    |
| Price (27 Jul 09)            | €2.46        |
| Target price                 | €3.00        |
| Expected share price return  | 22.1%        |
| Expected dividend yield      | 6.7%         |
| <b>Expected total return</b> | <b>28.8%</b> |
| Market Cap                   | €4,917M      |
|                              | US\$6,985M   |

### Price Performance (RIC: TRN.MI, BB: TRN IM)



### TERNA SpA (EUR)

| Year to 31 Dec        | 2007A   | 2008A   | 2009E   | 2010E   | 2011E   |
|-----------------------|---------|---------|---------|---------|---------|
| Sales (€M)            | 1,348.2 | 1,396.0 | 1,517.7 | 1,618.3 | 1,684.5 |
| Net Income (€M)       | 413.9   | 328.3   | 348.0   | 352.2   | 388.9   |
| Diluted EPS (€)       | 0.21    | 0.16    | 0.17    | 0.18    | 0.19    |
| Diluted EPS (Old) (€) | 0.21    | 0.16    | 0.17    | 0.18    | 0.19    |
| PE (x)                | 11.9    | 15.0    | 14.1    | 14.0    | 12.7    |
| EV/EBITDA (x)         | 7.6     | 8.0     | 7.8     | 7.8     | 7.7     |
| DPS (€)               | 0.16    | 0.16    | 0.17    | 0.18    | 0.18    |
| Net Div Yield (%)     | 6.5     | 6.7     | 6.9     | 7.1     | 7.1     |

### Alberto Ponti

 +39-02-8648-4211  
 alberto.ponti@citi.com

See Appendix A-1 for Analyst Certification and important disclosures.

| Fiscal year end 31-Dec                   | 2007         | 2008         | 2009E         | 2010E         | 2011E         |
|------------------------------------------|--------------|--------------|---------------|---------------|---------------|
| <b>Valuation Ratios</b>                  |              |              |               |               |               |
| P/E adjusted (x)                         | 11.9         | 15.0         | 14.1          | 14.0          | 12.7          |
| EV/EBITDA adjusted (x)                   | 7.6          | 8.0          | 7.8           | 7.8           | 7.7           |
| P/BV (x)                                 | 2.2          | 2.3          | 2.3           | 2.2           | 2.2           |
| Dividend yield (%)                       | 6.5          | 6.7          | 6.9           | 7.1           | 7.1           |
| <b>Per Share Data (€)</b>                |              |              |               |               |               |
| EPS adjusted                             | 0.21         | 0.16         | 0.17          | 0.18          | 0.19          |
| EPS reported                             | 0.21         | 0.16         | 0.17          | 0.18          | 0.19          |
| BVPS                                     | 1.14         | 1.08         | 1.09          | 1.10          | 1.12          |
| DPS                                      | 0.16         | 0.16         | 0.17          | 0.18          | 0.18          |
| <b>Profit &amp; Loss (€M)</b>            |              |              |               |               |               |
| Net sales                                | 1,348        | 1,396        | 1,518         | 1,618         | 1,685         |
| Operating expenses                       | -626         | -681         | -706          | -754          | -756          |
| <b>EBIT</b>                              | <b>723</b>   | <b>715</b>   | <b>812</b>    | <b>864</b>    | <b>929</b>    |
| Net interest expense                     | -117         | -180         | -236          | -279          | -285          |
| Non-operating/exceptionals               | 0            | 0            | 0             | 0             | 0             |
| <b>Pre-tax profit</b>                    | <b>606</b>   | <b>535</b>   | <b>576</b>    | <b>586</b>    | <b>644</b>    |
| Tax                                      | -173         | -193         | -214          | -219          | -241          |
| Extraord./Min.Int./Pref.div.             | -19          | -14          | -14           | -14           | -14           |
| <b>Reported net income</b>               | <b>414</b>   | <b>328</b>   | <b>348</b>    | <b>352</b>    | <b>389</b>    |
| Adjusted earnings                        | 414          | 328          | 348           | 352           | 389           |
| Adjusted EBITDA                          | 978          | 996          | 1,119         | 1,216         | 1,284         |
| <b>Growth Rates (%)</b>                  |              |              |               |               |               |
| Sales                                    | 3.2          | 3.5          | 8.7           | 6.6           | 4.1           |
| EBIT adjusted                            | 5.2          | -1.1         | 13.5          | 6.5           | 7.5           |
| EBITDA adjusted                          | 8.8          | 1.8          | 12.4          | 8.7           | 5.6           |
| EPS adjusted                             | 12.4         | -20.7        | 6.0           | 1.2           | 10.4          |
| <b>Cash Flow (€M)</b>                    |              |              |               |               |               |
| <b>Operating cash flow</b>               | <b>849</b>   | <b>537</b>   | <b>782</b>    | <b>749</b>    | <b>704</b>    |
| Depreciation/amortization                | 255          | 280          | 307           | 352           | 355           |
| Net working capital                      | 47           | -101         | 127           | 44            | -40           |
| <b>Investing cash flow</b>               | <b>-659</b>  | <b>-748</b>  | <b>-1,910</b> | <b>-785</b>   | <b>-610</b>   |
| Capital expenditure                      | -600         | -747         | -785          | -785          | -610          |
| Acquisitions/disposals                   | -60          | -1           | -1,125        | 0             | 0             |
| <b>Financing cash flow</b>               | <b>-146</b>  | <b>866</b>   | <b>225</b>    | <b>36</b>     | <b>-94</b>    |
| Borrowings                               | 415          | 1,380        | 582           | 376           | 256           |
| Dividends paid                           | -311         | -320         | -330          | -340          | -350          |
| <b>Change in cash</b>                    | <b>44</b>    | <b>656</b>   | <b>-902</b>   | <b>0</b>      | <b>0</b>      |
| <b>Balance Sheet (€M)</b>                |              |              |               |               |               |
| <b>Total assets</b>                      | <b>8,044</b> | <b>9,455</b> | <b>10,122</b> | <b>10,537</b> | <b>10,795</b> |
| Cash & cash equivalent                   | 247          | 902          | 0             | 0             | 0             |
| Accounts receivable                      | 1,541        | 1,730        | 1,663         | 1,640         | 1,640         |
| Net fixed assets                         | 5,613        | 6,036        | 6,899         | 7,722         | 8,005         |
| <b>Total liabilities</b>                 | <b>5,770</b> | <b>7,291</b> | <b>7,940</b>  | <b>8,343</b>  | <b>8,562</b>  |
| Accounts payable                         | 1,772        | 1,881        | 1,931         | 1,950         | 1,909         |
| Total Debt                               | 2,916        | 4,295        | 4,878         | 5,254         | 5,510         |
| <b>Shareholders' funds</b>               | <b>2,274</b> | <b>2,164</b> | <b>2,182</b>  | <b>2,194</b>  | <b>2,233</b>  |
| <b>Profitability/Solvency Ratios (%)</b> |              |              |               |               |               |
| EBITDA margin adjusted                   | 72.5         | 71.3         | 73.7          | 75.2          | 76.2          |
| ROE adjusted                             | 18.7         | 14.8         | 16.0          | 16.1          | 17.6          |
| ROIC adjusted                            | 9.8          | 8.4          | 8.6           | 8.4           | 8.4           |
| Net debt to equity                       | 117.4        | 156.8        | 223.6         | 239.5         | 246.8         |
| Total debt to capital                    | 56.2         | 66.5         | 69.1          | 70.5          | 71.2          |

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# 1H09 Preview

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Figure 1. Summary 1H results (€ m)

|                   | <b>1H08 A</b> | <b>1H09 E</b> | <b>Growth</b> | <b>Cons.</b> |
|-------------------|---------------|---------------|---------------|--------------|
| Total revenues    | 668           | 618           | -7.5%         | 633          |
| Opex              | (189)         | (164)         |               |              |
| EBITDA            | 479           | 454           | -5.3%         | 462          |
| D&A               | (132)         | (130)         |               |              |
| EBIT              | 347           | 324           | -6.8%         | 318          |
| Financial charges | (23)          | (76)          |               |              |
| PBT               | 325           | 247           | -23.8%        |              |
| Taxes             | (109)         | (90)          |               |              |
| Minorities        | (12)          | 18            |               |              |
| Net profits       | 204           | 176           | -13.9%        | 172          |

Source: Company reports, Citi Investment Research and Analysis, Bloomberg consensus.

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# TERNA SpA

## Company description

TERNA is the electricity transmission company of Italy, holding a market share of c.96%. Its transmission operations are entirely regulated, as are its operations in Brazil. In Italy, TERNA also provides transmission services to ENEL, its parent company, as well as to other clients outside the ENEL group.

## Investment strategy

We rate Terna Buy/Medium Risk (1M). We believe Terna is a solid defensive stock that benefits from a clear and stable regulatory environment that allows for incentives on investments for new infrastructure. We expect volumes in the electricity market to be driven by a more extensive use of electricity for residential and industrial usages, allowing for an average growth of c.1% pa. Thanks to the regulatory framework, Terna distinguishes itself for its earnings and cash flow predictability that we believe make it a stock to favour for those investors seeking defensiveness in the sector.

## Valuation

We value Terna using a RAB-based approach for its Italian transmission activities, which are the core business of Terna. To this end, we adopt a RAB-based DCF where for the terminal value we use the RAB as at the end of 2015 (coinciding with the end of the third regulatory period) whereas over 2009-14 we discount the cash flows that we estimate Terna will generate given the allowed return (by the regulator) of 6.9% (real, pre-tax) on its existing assets and the 2.6% premium allowed on new investments. These cash flows are then discounted using a WACC in line with the allowed return. This valuation is then benchmarked against the trading multiples of comparable European utilities and results in a premium to RAB (end of 2009) of 11%, which is consistent with the premium observed for similar regulated businesses in Europe. For its non-core activities, we use a 2009E EV/EBITDA multiple of 7x. Our SOTP valuation is €3.00, which is where we set our target price. We then compare Terna's profits and EBITDA to the multiples of other listed European utilities

## Risks

We rate Terna Medium Risk because of the following factors that could prevent achievement of our target price. Terna's profitability could be undermined by investments outside Italy, such as those in Brazil and the Balkans, for which at present we have little information and could increase the risks of Terna's operations. In the Balkans, where state-owned companies are being privatised and little is known about regulation and regulators, which, where they exist, have no proven track record in terms of stability and consistency, Terna could decide to commit more capital were opportunities to arise. Although on the one hand we acknowledge that such investments could potentially be profitable, on the other hand the lower transparency of regulation would alter Terna's overall risk profile, increasing it. Finally, Terna faces the risk that some of its projects could be delayed or executed at a cost that is higher than that recognised by the regulator. Also, the government could decide to levy taxes on regulated utilities, thus affecting its profitability. We think risks of new taxes or a negative regulatory review are the main risks that could impede the share price reaching our target price. On the upside, the fact that Terna could announce more cost savings or a higher capex plan than we expect, could lead the share price to exceed our target price.

# Appendix A-1

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#### Ratings and Target Price History

#### Fundamental Research

Analyst: Alberto Ponti



|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 1 | 29-Nov-06 | *2M    | *2.50        | 2.55          |
| 2 | 31-Jan-07 | *1M    | *2.85        | 2.66          |

|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 3 | 12-May-08 | *2M    | *3.00        | 2.84          |
| 4 | 9-Feb-09  | *1M    | 3.00         | 2.48          |

\* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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