

## COMPANY UPDATE

# Terna (TRN.MI)

Sell

## Short-term forecasts increased but limited upside potential; Sell

### What's changed

We have updated our forecasts and valuation after 1H results and to reflect some minor changes to our modeling. Terna's results were ahead of our expectations at the net income level, and we have also reflected the company's more positive guidance for the current year.

### Implications

As a result of the changes, we have increased our EBITDA and EPS forecasts by 2% and 8% for 2010. Our 2011-12 EPS forecasts have increased by only 1%. Terna guided for higher revenues from dispatching incentives in 2010 and we now forecast €70 mn (from €45 mn) from this line in 2010. However, we assume this large benefit only lasts for one year, and we have not changed our assumptions beyond 2010. We have also increased the total level of capex spent on Suntergrid (solar) to €450 mn, in line with guidance, and lowered financial charges for all forecast years to reflect higher capitalized interest. We forecast EBITDA of €1.14 bn for 2010 (company guidance > €1.1 bn, Reuters consensus €1.11 bn), and net income of €437 mn, ahead of consensus (€403 mn).

### Valuation

Following these changes, our 12-month, RAB-SOTP-based price target is unchanged at €3.3. While Terna has continued to deliver strong results and surprise positively (1H results were almost 10% ahead of our ahead-of-consensus forecasts at net income), we believe that the low cost of debt is unlikely to be sustainable long term, and that good results have been achieved more by several positive one-offs than structural improvements. We see 5% potential upside to our price target, well below the average for the utilities sector of c.30%, and we retain a Sell rating.

### Key risks

Key risks to our view and rating are favourable changes to regulation, and a continued low cost of debt (we assume it gradually rises).

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Pan-Europe Sell List

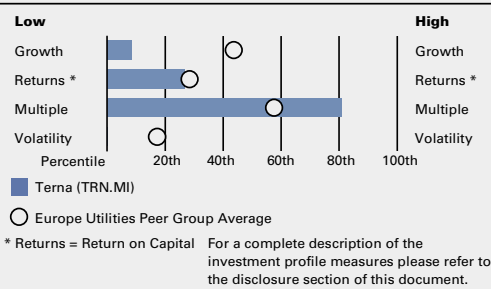
### Coverage View: Cautious

Italy  
Power

**Matija Gergolet**  
+44(20)7552-3519 matija.gergolet@gs.com Goldman Sachs International

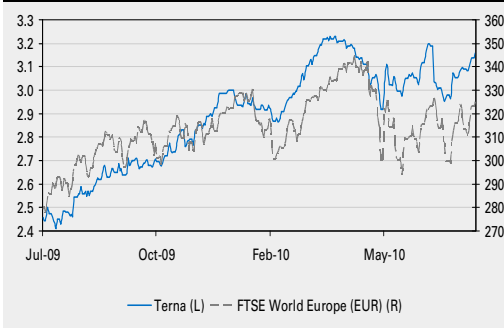
**Fred Barasi**  
+44(20)7552-1168 fred.barasi@gs.com Goldman Sachs International

### Investment Profile



Key data	Current			
Price (€)	3.16			
12 month price target (€)	3.30			
Upside/(downside) (%)	5			
Market cap (€ mn)	6,317.9			
Enterprise value (€ mn)	10,890.5			
	12/09	12/10E	12/11E	12/12E
<b>Revenue (€ mn) New</b>	<b>1,360.7</b>	<b>1,556.1</b>	<b>1,673.7</b>	<b>1,723.0</b>
Revenue revision (%)	0.0	3.5	2.1	2.5
<b>EBIT (€ mn) New</b>	<b>694.4</b>	<b>778.6</b>	<b>836.3</b>	<b>852.3</b>
EBIT revision (%)	0.0	3.2	(0.9)	(2.0)
<b>EPS (€) New</b>	<b>0.39</b>	<b>0.22</b>	<b>0.22</b>	<b>0.21</b>
EPS (€) Old	0.39	0.20	0.22	0.21
EV/EBITDA (X)	9.0	9.6	9.4	9.5
P/E (X)	6.6	14.4	14.2	14.9
Dividend yield (%)	7.5	6.1	6.2	6.2
FCF yield (%)	(3.9)	(9.0)	(4.9)	(3.9)
CROCI (%)	6.5	6.6	6.5	6.3

### Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	1.9	7.6	28.5
Rel. to FTSE World Europe (EUR)	7.3	4.7	10.3

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 7/26/2010 close.

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# Terna: Summary Financials

Profit model (€ mn)	12/09	12/10E	12/11E	12/12E	Balance sheet (€ mn)	12/09	12/10E	12/11E	12/12E
Total revenue	1,360.7	1,556.1	1,673.7	1,723.0	Cash & equivalents	501.1	501.1	501.1	501.1
Operating costs	(357.5)	(415.8)	(437.0)	(442.5)	Accounts receivable	1,169.1	1,260.5	1,339.0	1,378.4
R&D	--	--	--	--	Inventory	11.7	11.7	11.7	11.7
Lease payments	0.0	0.0	0.0	0.0	Other current assets	18.4	30.3	33.5	34.8
Other operating profit/(expense)	0.0	0.0	0.0	0.0	<b>Total current assets</b>	<b>1,700.3</b>	<b>1,803.6</b>	<b>1,885.2</b>	<b>1,926.0</b>
<b>EBITDA</b>	<b>1,003.2</b>	<b>1,140.3</b>	<b>1,236.7</b>	<b>1,280.4</b>	Net PP&E	7,075.4	7,933.6	8,518.3	8,950.1
Depreciation & amortisation	(308.8)	(361.8)	(400.3)	(428.2)	Net intangibles	182.0	192.0	202.0	212.0
<b>EBIT</b>	<b>694.4</b>	<b>778.6</b>	<b>836.3</b>	<b>852.3</b>	Total investments	144.2	144.2	144.2	144.2
Net interest income/(expense)	(148.3)	(110.9)	(153.1)	(199.8)	Other long-term assets	217.8	217.8	217.8	217.8
Associates	0.0	0.0	0.0	0.0	<b>Total assets</b>	<b>9,319.7</b>	<b>10,291.2</b>	<b>10,967.5</b>	<b>11,450.1</b>
Profit/(loss) on disposals	0.0	0.0	0.0	0.0	Accounts payable	1,482.0	0.0	0.0	0.0
Others (recurring)	0.0	0.0	0.0	0.0	Short-term debt	99.7	0.0	0.0	0.0
<b>Pretax profits</b>	<b>546.1</b>	<b>667.6</b>	<b>683.3</b>	<b>652.5</b>	Other current liabilities	164.8	1,711.7	1,757.4	1,723.0
Income tax	(192.1)	(230.2)	(236.9)	(229.1)	<b>Total current liabilities</b>	<b>1,746.5</b>	<b>1,711.7</b>	<b>1,757.4</b>	<b>1,723.0</b>
Tax rate (%)	35.2	34.5	34.7	35.1	Long-term debt	4,199.2	5,149.4	5,741.6	6,248.6
Minorities	0.0	0.0	0.0	0.0	Other long-term liabilities	872.5	847.5	822.5	797.5
Preferred dividends	0.0	0.0	0.0	0.0	<b>Total long-term liabilities</b>	<b>5,071.7</b>	<b>5,996.9</b>	<b>6,564.1</b>	<b>7,046.1</b>
<b>Net income (pre-exceptionals)</b>	<b>354.0</b>	<b>437.4</b>	<b>446.4</b>	<b>423.4</b>	<b>Total liabilities</b>	<b>6,818.2</b>	<b>7,708.6</b>	<b>8,321.5</b>	<b>8,769.1</b>
Other non-recurring items post tax	417.0	0.0	0.0	0.0	Preferred shares	0.0	0.0	0.0	0.0
<b>Net income</b>	<b>771.0</b>	<b>437.4</b>	<b>446.4</b>	<b>423.4</b>	<b>Total common equity</b>	<b>2,501.5</b>	<b>2,582.6</b>	<b>2,646.0</b>	<b>2,681.0</b>
<b>EPS (underlying) (€)</b>	<b>0.18</b>	<b>0.22</b>	<b>0.22</b>	<b>0.21</b>	<b>Minority interest</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
EPS (basic, reported) (€)	0.39	0.22	0.22	0.21	<b>Total liabilities &amp; equity</b>	<b>9,319.7</b>	<b>10,291.2</b>	<b>10,967.5</b>	<b>11,450.1</b>
Weighted shares outstanding (mn)	2,000.9	2,000.9	2,000.9	2,000.9	Capitalised leases	0.0	0.0	0.0	0.0
Common dividends declared	380.2	385.0	390.6	390.9	<b>Capital employed</b>	<b>6,800.4</b>	<b>7,732.0</b>	<b>8,387.6</b>	<b>8,929.6</b>
DPS (€)	0.19	0.19	0.20	0.20	Adj for unfunded pensions & GW	(274.5)	(269.5)	(264.5)	(259.5)
Dividend payout ratio (%)	107.4	88.0	87.5	92.3	<b>Adj capital employed</b>	<b>6,525.9</b>	<b>7,462.5</b>	<b>8,123.1</b>	<b>8,670.1</b>
Dividend cover (X)	0.9	1.1	1.1	1.1	<b>Gross cash invested</b>	<b>12,287.0</b>	<b>13,565.4</b>	<b>14,606.4</b>	<b>15,561.5</b>
<b>Growth &amp; margins (%)</b>	<b>12/09</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>	<b>Ratios</b>	<b>12/09</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Revenue growth	(2.5)	14.4	7.6	2.9	CROCI (%)	6.5	6.6	6.5	6.3
EBITDA growth	0.9	13.7	8.4	3.5	CROCI/WACC (X)	1.1	1.1	1.2	1.1
EBIT growth	(2.8)	12.1	7.4	1.9	ROIC (%)	8.8	7.1	6.8	6.4
Net income growth	135.4	(43.3)	2.1	(5.2)	ROIC/WACC (X)	1.4	1.2	1.2	1.2
EPS growth	8.1	23.6	2.1	(5.2)	ROA (%)	3.8	4.5	4.2	3.8
DPS growth	20.3	1.3	1.5	0.1	WACC (%)	6.1	5.7	5.6	5.5
EBITDA margin	73.7	73.3	73.9	74.3	Inventory days	3.1	2.7	2.6	2.5
EBIT margin	51.0	50.0	50.0	49.5	Asset turnover (X)	0.2	0.2	0.2	0.2
<b>Cash flow statement (€ mn)</b>	<b>12/09</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>	Net debt/equity (%)	151.8	180.0	198.1	214.4
Net income	354.0	437.4	446.4	423.4	EBITDA interest cover (X)	6.8	10.3	8.1	6.4
D&A add-back (incl. ESO)	308.8	361.8	400.3	428.2	<b>Valuation</b>	<b>12/09</b>	<b>12/10E</b>	<b>12/11E</b>	<b>12/12E</b>
Minority interest add-back	0.0	0.0	0.0	0.0	EV/sales (X)	6.5	6.9	6.8	6.9
Net (inc)/dec working capital	159.7	(38.3)	(36.0)	(75.2)	EV/EBITDAR (X)	8.8	9.4	9.2	9.3
Other operating cash flow	(25.0)	(25.0)	(25.0)	(25.0)	EV/EBITDA (X)	8.8	9.4	9.2	9.3
<b>Cash flow from operations</b>	<b>797.5</b>	<b>735.9</b>	<b>785.7</b>	<b>751.4</b>	EV/EBIT (X)	12.7	13.7	13.6	14.0
Capital expenditures	(878.0)	(1,230.0)	(995.0)	(870.0)	P/E (X)	14.3	14.4	14.2	14.9
Acquisitions	(1,212.1)	0.0	0.0	0.0	Dividend yield (%)	7.5	6.1	6.2	6.2
Divestitures	847.6	0.0	0.0	0.0	FCF yield (%)	(3.9)	(9.0)	(4.9)	(3.9)
Others	0.0	0.0	0.0	0.0	EV/GCI (X)	0.7	0.8	0.8	0.8
<b>Cash flow from investing</b>	<b>(1,242.5)</b>	<b>(1,230.0)</b>	<b>(995.0)</b>	<b>(870.0)</b>	EV/adj. capital employed (X)	1.5	1.6	1.5	1.5
Dividends paid (common & pref)	(337.8)	(356.3)	(383.0)	(388.4)	Price/book (X)	2.4	2.4	2.4	2.4
Inc/(dec) in debt	104.4	850.5	592.3	507.0	Note: Ratios are adjusted for leases where appropriate. Only separately disclosed where significant and ongoing.				
Other financing cash flows	0.0	0.0	0.0	0.0	Note: Last actual year may include reported and estimated data.				
<b>Cash flow from financing</b>	<b>(233.4)</b>	<b>494.1</b>	<b>209.3</b>	<b>118.6</b>	Source: Company data, Goldman Sachs Research estimates.				
<b>Total cash flow</b>	<b>(278.6)</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>					
Capex/D&A (%)	284.3	340.0	248.5	203.2					
Reinvestment rate (%)	137.7	158.9	121.1	105.3					
Cash flow cover of dividends (X)	1.7	2.0	2.1	2.1					
Free cash flow cover of dividends (X)	(0.5)	(1.5)	(0.8)	(0.6)					

## Analyst Contributors

### Matija Gergolet

matija.gergolet@gs.com

### Fred Barasi

fred.barasi@gs.com

## RAB-based SOTP price target for Terna remains at €3.3/share

### Exhibit 1: Our 12-month price target is €3.3

Terna RAB-based SOTP			
RAB-based valuation for end 2010E	EUR mn	EUR ps	Notes
Italian RAB end 2010E	9,618	4.81	Rab used for 2011 tariffs (18 months time lag)
Investment in solar projects	326	0.16	Total invested capital
Non regulated activities	267	0.13	6x 2010E EBITDA
Less net debt	-4,648	-2.32	End 2010E net debt
Debt FV (end 2009)	121	0.06	2009 reported value
Other liabilities	-144	-0.07	Provisions for risks end 2010E
<b>Terna equity-RAB value</b>	<b>5,540</b>	<b>2.77</b>	<b>Equity-RAB end 2010E</b>
NPV cost outperformance (including GRN dispatching)	165	0.08	Small opex outperformance
NPV spread between returns WACC	117	0.06	c.0.3% return spread for one more regulatory period (to 2016)
NPV 2-3% incentive on c.€5bn of expansion capex to 2015	785	0.39	2-3% incremental return to 2016, incentives last for 12 years
NPV from solar projects	135	0.07	30% premium to invested capital
Deferred taxes	-205	-0.10	Assuming €20mn pa cash outflows
<b>Total RAB-value adjustments</b>	<b>997</b>	<b>0.50</b>	<b>Implies 18% premium to equity RAB</b>
<b>Total RAB-based valuation for Terna</b>	<b>6,537</b>	<b>3.3</b>	

Source: Company data, Goldman Sachs Research estimates.

## Forecasts and valuation updated and remodeled – no change to PT

Following Terna's 1H results, and a review of our existing model, we have made a number of changes to our assumptions and modeling. The major changes to forecasts are as follows:

- Reflecting updated guidance at 1H results – higher dispatching revenues in 2010E, more capex on Suntergrid and lower financial charges
- Slightly increased capex for 2012-14E; and
- Updated assumptions for CPI and deflator

We have also made the following key changes to our valuation:

- Revised the RAB value to reflect updated CPI assumptions and asset retirements, resulting in the RAB estimate being reduced by €0.2/share;
- Increased the value of non-regulated activities to reflect greater forecast EBITDA from this segment (+€0.06/share);
- Included a debt fair value adjustment for consistency with other regulated stocks (+€0.06/share); and
- Higher benefit given to value creation (total €0.40/share, up from €0.35/share), reflecting incentive payments for work-in-progress, and higher investment in solar projects.

We assume that capex incentives remain unchanged until 2015 (i.e., for the remainder of this regulatory period and the following period), and that Terna is also able to outperform the regulator's assumptions on cost of capital and operating costs until 2015. As for other regulated stocks, we do not assume Terna enjoys any incentives or outperformance (financial or operational) on investments in electricity infrastructure assets beyond 2015.

Overall, the lower RAB is offset by higher value creation and non-regulated activities, and our 12-month price target is unchanged at €3.3.

## Reg AC

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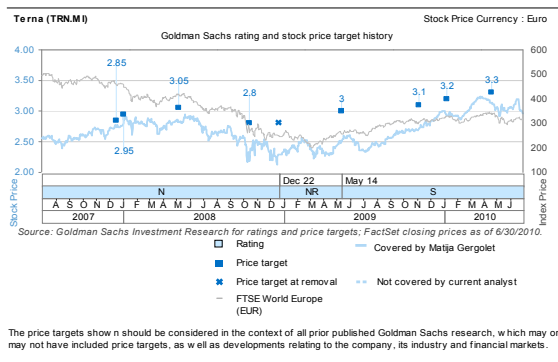
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## Price target and rating history chart(s)



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