

Italy: Utilities

Equity Research

Bond yields continue to squeeze likely returns: Snam down to Sell

Italian regulation risk breaks the bond link for Italian utilities...

We have argued in recent research that certain regulated utilities, where no regulatory reviews are due for five years or more and dividend visibility is high, could be viewed as bond proxies. However, we believe the Italian regulated utilities Snam and Terna are not candidates for such a valuation approach: not only do they both face a regulatory reset in 2016 (decision to be announced in November 2015), but returns will be updated again in 2018, meaning that dividends can only ever be truly secure for a two-year period (barring a change to the regulatory model).

... making falling bond yields a negative dynamic

With these issues making it unlikely that regulated Italian utilities will track bond prices, different dynamics take hold. Falls in Italian bond yields (10y now 1.1%) do not provide a driver for capital appreciation but reduce headroom for allowed returns. We now expect electricity and gas transport to face a 220 bp cut in 2016, driving a c.25% EPS cut for Snam/Terna.

Snam's recent outperformance unjustified; downgrade to Sell

Despite this negative macro backdrop, Snam has outperformed European utilities by 7% ytd and now trades at a 25% premium to RAB, close to its highest level since 2007. Snam's FY14 results and strategy outlook lead us to reduce earnings forecasts (we are 3%-6% below Reuters consensus 2016-17 EPS) and we cut our 12m price target to €4.1. With 9% absolute and c.20% sector relative downside potential, we downgrade Snam to Sell.

Terna remains CL-Sell, 6% potential downside

We continue to rate Terna a Sell and it remains on our Conviction List. Our EBITDA forecasts are 7%-9% below Reuters consensus in 2016/17 (EPS in line), and although we expect Terna to maintain its DPS in 2016E, this implies a payout of 88%, above both Terna's historical peak payout and the average for European regulated utilities. Despite these risks, Terna trades at a 31% premium to RAB, which we believe is unjustified and at risk.

EPS for Enel, Hera, A2A cut by 0%-1%, Hera remains CL-Buy

We reiterate our CL-Buy on Hera as we continue to expect strong growth (12% EPS CAGR 2014-18E), driven by M&A, growth capex, waste growth, and a lower cost of debt, which more than offset lower regulated returns.

ITALIAN UTILITIES WITH EXPOSURE TO REGULATED ASSETS

Company	12m PT	Share price	Upside	Rating
Hera	2.95	2.21	33%	Buy **
A2a	1.05	0.95	10%	Buy
Enel	4.40	4.11	7%	Neutral
Snam	4.10	4.50	-9%	Sell
Terna	3.75	3.99	-6%	Sell **

** denotes membership of Conviction List; prices as of the close of March 13, 2015

Source: Goldman Sachs Global Investment Research.

COVERAGE VIEW: NEUTRAL

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Reducing expectations for allowed returns as bond yields fall

We have further reduced our expectations for allowed regulated returns for electricity and gas transport, distribution and storage from 2016 to reflect current Italian bond yields. We now assume a c.220 bp reduction in returns vs. our previous expectation of 170-180 bp. Our full assumptions are set out below.

Exhibit 1: We forecast a cut in allowed returns of c.220 bp for transport and distribution

Current and forecast regulated returns in Italy

Year of review:	Current returns:			Forecast returns:		
	2013	2013	2014	2015	2015	2015
	TRANSMISSION	DISTRIBUTION	STORAGE	TRANSMISSION	DISTRIBUTION	STORAGE
	Gas	Gas	Gas	Gas	Gas	Gas
	FINAL	FINAL	FINAL	GSf	GSf	GSf
Effective period	2014-17	2014-19	2015	2016-17	2016-17	2016-18
Main company affected:	Snam	Snam, A2A, Hera	Snam	Snam	Snam, A2A, Hera	Snam
Risk-free rate	4.41%	4.41%	3.35%	1.42%	1.42%	1.42%
Equity risk premium	4.00%	4.00%	4.00%	4.00%	4.00%	4.00%
Unlevered beta	0.36	0.44	0.51	0.36	0.44	0.51
Levered beta	0.569	0.631	0.800	0.575	0.631	0.800
Cost of equity, nominal	6.69%	6.94%	6.55%	3.72%	3.95%	4.62%
Cost of debt, nominal	4.86%	4.86%	3.80%	1.87%	1.87%	1.87%
Inflation	1.8%	1.8%	1.5%	0.00%	0.00%	0.00%
Tax rate for tax shield (IRES)	27.5%	27.5%	27.5%	27.5%	27.5%	27.5%
IRAP tax rate	35.7%	35.7%	35.7%	35.7%	35.7%	35.7%
Gearing (D/E)	80%	60%	80%	80%	60%	80%
ALLOWED RETURN (pretax, real)	6.3%	6.9%	6.0%	4.15%	4.63%	4.93%

Year of review:	2013	2013		2015	2015
	TRANSMISSION	DISTRIBUTION		TRANSMISSION	DISTRIBUTION
	Electricity	Electricity		Electricity	Electricity
	GSf	GSf		GSf	GSf
Effective period	2014-15	2014-15		2016-21	2016-21
Main company affected:	Terna	Enel, A2A, Hera		Terna	Enel, A2A, Hera
Risk-free rate	4.41%	4.41%		1.42%	1.42%
Equity risk premium	4.00%	4.00%		4.00%	4.00%
Unlevered beta	0.36	0.39		0.36	0.39
Levered beta	0.575	0.610		0.575	0.610
Cost of equity, nominal	6.71%	6.85%		3.72%	3.86%
Cost of debt, nominal	4.86%	4.86%		1.87%	1.87%
Inflation	1.8%	1.8%		0.00%	0.00%
Tax rate for tax shield (IRES)	27.5%	27.5%		27.5%	27.5%
IRAP tax rate	35.7%	35.7%		35.7%	35.7%
Gearing (D/E)	80%	80%		80%	80%
ALLOWED RETURN (pretax, real)	6.3%	6.4%		4.15%	4.27%

Source: AEEG, Goldman Sachs Global Investment Research.

Key risks are inflation and risk-free rate

We assume a risk-free rate of 1.42%, based on the average 10-year government bond yield since November 2014 and assuming a rate of 1.19% (last five-day average) for the remainder of the 12-month period. We also assume an inflation rate of 0% (the lower the better for the allowed return), and that all other parameters are unchanged. Each 10 bp higher risk-free rate would increase 2016E EPS for Snam/Terna by c.3%, while each 10 bp lower inflation assumed would increase 2016E EPS by c.2%.

Robin Hood tax claw-back less likely as base returns fall

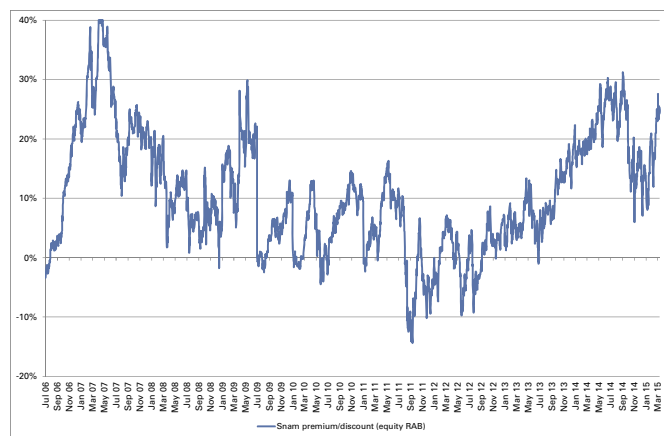
The 6.5% Robin Hood tax has been deemed unconstitutional, and we assume will no longer be levied on the utilities. We have previously assumed (see *Terna expensive even if "Robin Hood" tax removed; remain CL Sell*, February 12) that part of the benefit of the Robin Hood tax removal could be clawed back by the regulator, on the basis that allowed revenues were increased in 2011 following the Robin Hood tax being extended to network activities. However given our increasingly bearish expectations for allowed returns, we believe applying an additional revenue cut is unrealistic, and we have removed this cut. This is most significant for Snam and Terna where we had cut revenues by €50 mn and €36 mn pa from 2016E (equivalent to c.4%-5% at net income).

Valuation: Snam has caught up with Terna's premium

Snam's recent outperformance has left it on a premium to RAB of 25%, close to Terna's 31% premium. In both cases the stocks are at a material premium compared to their historical average level, and close to the highest levels since 2007 (for Snam). We believe that the likely cut to allowed returns means neither of these premia are justified.

Exhibit 2: Snam's recent rally has increased its premium to RAB to 25%...

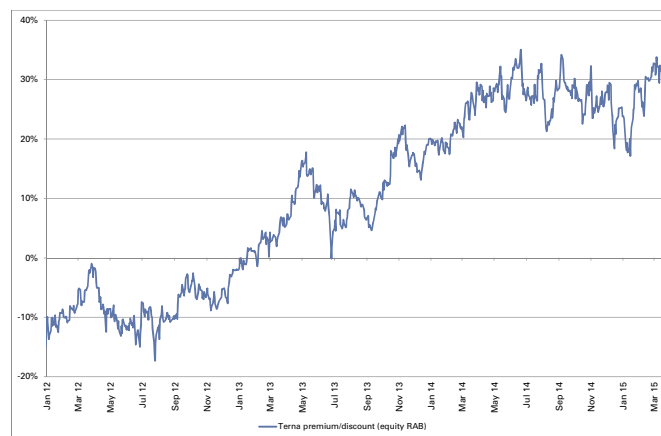
Premium/discount to RAB for Snam (equity basis)



Source: Company data, Goldman Sachs Global Investment Research.

Exhibit 3: ...while Terna continues to trade at a >30% premium

Premium/discount to RAB for Terna (equity basis)



Source: Company data, Goldman Sachs Global Investment Research.

On more traditional valuation metrics, Snam and Terna both also trade at a premium to the European utilities sector average on P/E (c.20% in 2016E) and EV/EBITDA (40% in 2016E). While they both offer above average dividend yields, these reflect a payout ratio of 88%-95% and we expect no growth in DPS to 2018E. Both Snam and Terna have net debt/EBITDA of more than 5.5x in 2016E.

Exhibit 4: Terna and Snam both appear unattractive on P/E and EV/EBITDA metrics in 2016E

European regulated utilities comparison

Regulated utilities	Italy		Spain		Belgium	Portugal	UK				Average (regulated)	Average (Euro utils)
	Terna	Snam	Enagas	REE	Elia	REN	UU	SVT	Pennon	NG		
P/E (2015E)	13.1	13.1	15.0	16.0	17.7	17.3	18.5	22.8	21.5	13.9	16.9	15.5
P/E (2016E)	17.5	17.1	14.4	14.4	16.5	16.2	19.1	25.3	19.5	13.7	17.4	14.7
EV/EBITDA (2015E)	10.1	10.0	9.9	10.5	14.7	8.1	10.7	10.3	13.2	10.5	10.8	8.6
EV/EBITDA (2016E)	11.9	11.8	10.2	10.1	14.1	7.8	10.6	10.5	12.4	10.2	11.0	8.3
Dividend yield (2015E)	5.0%	5.6%	5.1%	4.4%	3.9%	6.2%	4.3%	4.1%	4.3%	5.1%	4.8%	4.3%
Dividend yield (2016E)	5.0%	5.6%	5.3%	4.7%	3.9%	6.3%	4.4%	4.2%	4.6%	5.2%	4.9%	4.7%
Payout ratio (2016E)	88%	95%	77%	68%	65%	101%	84%	107%	90%	71%	85%	68%
Growth rates:												
EPS CAGR (2015-18E)	-7%	-5%	4%	6%	8%	-2%	2%	1%	7%	1%	1%	8%
EPS CAGR (2015-17E)	-11%	-11%	4%	8%	7%	-2%	0%	-2%	8%	1%	0%	7%
DPS CAGR (2015-18E)	0%	0%	6%	7%	3%	1%	3%	3%	8%	2%	3%	6%
Balance sheet/Cashflow:												
ND/EBITDA (2015E)	4.7	4.9	4.4	3.7	7.3	5.5	5.4	5.1	5.2	4.9	5.1	2.9
ND/EBITDA (2016E)	5.6	5.8	4.6	3.6	7.4	5.2	5.4	5.4	5.0	4.9	5.3	2.9
FCF yield (2015E)	7.4%	6.6%	6.6%	6.1%	4.2%	6.1%	6.8%	5.2%	4.7%	7.1%	6.1%	6.1%
FCF yield (2016E)	5.5%	4.7%	6.8%	6.8%	4.5%	6.4%	6.4%	3.4%	4.7%	7.5%	5.7%	5.8%

Source: Goldman Sachs Global Investment Research.

Updated forecasts for Snam and Terna

We have updated forecasts for Snam and Terna to reflect FY14 results and strategy update (Snam) and lower regulated returns (offset by removing the Robin Hood tax clawback) for both Snam and Terna. Our revised forecasts are shown below.

Exhibit 5: We have reduced our Snam forecasts by up to 8% at net income (2015-19E); we forecast RAB growth of 2%, slightly above the company's expectations of 1%

Updated Snam forecasts, changes to forecasts and comparison with Reuters consensus

Snam (EURmn)	2014	2015E	2016E	2017E	2018E	2019E	2015-18E CAGR
EBITDA	2,776	2,866	2,441	2,500	2,567	2,602	-4%
EBIT	1,973	2,026	1,569	1,598	1,635	1,640	-7%
Clean net income	1,083	1,205	917	947	1,020	1,044	-5%
EPS (clean)	0.32	0.34	0.26	0.27	0.29	0.30	-5%
DPS	0.25	0.25	0.25	0.25	0.25	0.25	0%
Payout	78%	73%	95%	92%	86%	84%	
ND/EBITDA (x)	5.0	4.9	5.9	5.9	5.8	5.8	
Net debt	13,652	13,728	14,116	14,447	14,696	14,916	2%
Cost of net debt (%)	3.1%	2.8%	2.6%	2.4%	2.1%	2.1%	
RAB	24,618	25,087	25,608	26,156	26,680	27,181	2%
Capex	1,277	1,255	1,227	1,226	1,226	1,226	-1%
Equity RAB (€/sh)	3.50	3.61	3.65	3.71	3.79	3.87	2%
Change to GSf	2014	2015E	2016E	2017E	2018E		
EBITDA	-2%	-2%	-5%	-6%	-6%		
EBIT	-4%	-3%	-9%	-10%	-9%		
Clean net income	-6%	-4%	-8%	-7%	-1%		
Capex	-37%	-16%	-19%	-20%	-20%		
Net debt	-2%	-4%	-7%	-8%	-10%		
EPS (clean)	-6%	-5%	-8%	-7%	-1%		
DPS	0%	0%	0%	0%	0%		
GSf v consensus	2014	2015E	2016E	2017E			
EBITDA		0%	-5%	-4%			
Net income		1%	-6%	-2%			
EPS (clean)		1%	-6%	-3%			
DPS		4%	0%	0%			

Source: Company data, Goldman Sachs Global Investment Research, Reuters.

Exhibit 6: Our Terna forecasts have been modestly reduced from 2016E and are 7%-9% below consensus at EBITDA in 2016/17E (in line at EPS)

Updated Terna forecasts, changes to forecasts and comparison with Reuters consensus

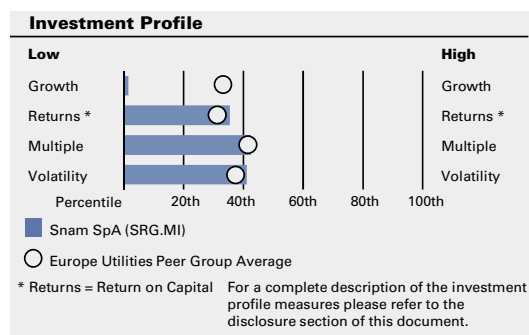
Terna (EURmn)	2014E	2015E	2016E	2017E	2018E	2019E	2015-18E CAGR
EBITDA	1,480	1,532	1,324	1,375	1,402	1,421	-3%
EBIT	1,022	1,059	842	883	906	921	-5%
Clean net income	535	611	458	484	499	509	-7%
Capex	1,021	921	726	586	586	586	-14%
Net debt	7,099	7,359	7,566	7,598	7,610	7,607	1%
Cost of net debt (%)	2.4%	2.4%	2.4%	2.4%	2.4%	2.4%	
EPS (clean)	0.27	0.30	0.23	0.24	0.25	0.25	-7%
DPS	0.20	0.20	0.20	0.20	0.20	0.20	0%
Payout	75%	66%	88%	83%	81%	79%	
Change to GSf	2014E	2015E	2016E	2017E	2018E		
EBITDA	0%	0%	-2%	-2%	-2%		
EBIT	0%	0%	-2%	-2%	-2%		
Clean net income	0%	1%	-1%	1%	4%		
Capex	0%	0%	0%	0%	0%		
Net debt	0%	0%	0%	0%	0%		
EPS (clean)	0%	1%	-1%	1%	4%		
DPS	0%	0%	0%	0%	0%		
GS v consensus	2014E	2015E	2016E	2017E			
EBITDA	0%	0%	-7%	-9%			
EBIT	1%	0%	-9%	-12%			
Net income	2%	13%	1%	-3%			
EPS (clean)	2%	9%	-1%	0%			
DPS	0%	0%	5%	-5%			

Source: Goldman Sachs Global Investment Research, Reuters.

Changes for Hera (CL-Buy), Enel (Neutral), A2A (Buy) not material; price targets unchanged

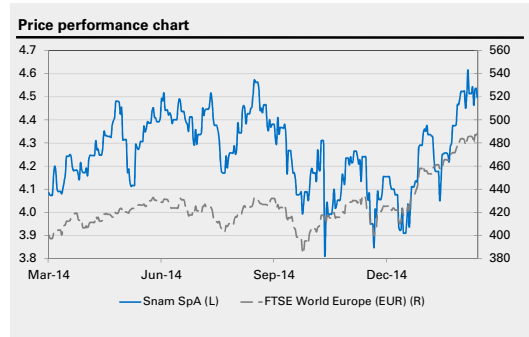
We have also updated our forecasts for Enel, Hera and A2A to reflect lower regulated returns (offset by removing the Robin Hood tax clawback). Our 2016-18E net income forecasts for Hera and A2A reduce by 1% and for Enel by 0%-1%. Our price targets for all three stocks are unchanged. For more details on Hera/A2A see: *"Time is now for start of sector consolidation, Hera CL-Buy, A2A Buy"*, March 9.

Snam SpA (SRG.MI): Down to Sell, premium to RAB unjustified



Key data	Current
Price (€)	4.50
12 month price target (€)	4.10
Upside/(downside) (%)	(9)
Market cap (€ mn)	16,053.5
Enterprise value (€ mn)	30,437.9

	12/14	12/15E	12/16E	12/17E
Revenue (€ mn) New	3,512.4	3,558.3	3,133.7	3,192.8
Revenue revision (%)	(9.0)	(9.8)	(13.2)	(13.7)
EBIT (€ mn) New	1,973.0	2,025.7	1,569.5	1,597.8
EBIT revision (%)	(4.0)	(3.3)	(8.7)	(9.5)
EPS (€) New	0.36	0.34	0.26	0.27
EPS (€) Old	0.34	0.36	0.28	0.29
EV/EBITDA (X)	9.9	10.1	11.9	11.7
P/E (X)	11.9	13.1	17.1	16.6
Dividend yield (%)	5.9	5.6	5.6	5.6
FCF yield (%)	3.9	3.9	2.5	2.8
CROCI (%)	6.2	6.0	5.0	5.0



Share price performance (%)	3 month	6 month	12 month
Absolute	13.8	0.7	10.1
Rel. to FTSE World Europe (EUR)	(4.7)	(12.0)	(9.7)

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 3/13/2015 close.

Source of opportunity

Following recent outperformance, Snam now trades at a 25% premium to RAB, close to its highest level since 2007. We believe this is unjustified given the c.25% EPS cut we expect in 2016, leaving Snam's dividend on a 95% pay-out (vs. 85% average for regulated utilities). Snam trades on a 20% P/E premium vs. the broader European utilities sector and a 40% EV/EBITDA premium (both 2016E), despite lower growth prospects (we forecast EPS CAGR of -5% 2015-18E) and a more levered balance sheet (5.8x ND/EBITDA in 2016E vs. sector average of 2.9x). We have reduced our 12-month price target to €4.1 following FY14 results and downgrade Snam to Sell with 9% potential downside.

Catalyst

We see the regulatory review of allowed returns in 2015 as the main catalyst for Snam. We expect the first draft from the regulator in April/May, with a second document in September and the final regulation due in November. We expect the allowed returns for Snam's main business (gas transport) to be cut to 4.15% from the current 6.3%.

Valuation

Our 12-month price target is now €4.1 (from €4.4). It is based on a 50:50 combination of a P/E valuation (€4.55) and a RAB-based SOTP valuation (€3.67). We see Snam on a 25% premium to current RAB and a 20% P/E premium to the broader sector, which we do not think can be justified given the risks from the regulatory review. Although we forecast DPS to remain stable in 2016, we see downside risks given the 95% payout ratio this implies, along with Snam's high gearing (ND/EBITDA 5.8x).

Key risks

The key risk to our view is a better regulatory review: either higher allowed returns owing to an increase in bond yields leading to a higher risk-free rate, or a lower inflation assumption, or a more generous opex/depreciation allowance.

Source: Company data, Goldman Sachs Global Investment Research, FactSet.

Our SOTP valuation for Snam is €3.67

Exhibit 7: Our SOTP valuation for Snam implies a small (3%) premium to equity RAB of €3.55

SOTP valuation forms 50% of our overall PT

Snam Rete Gas valuation	€ mn	€ per share	Notes
Estimated end 2015 transmission RAB	15,240	4.35	End 2015E RAB
Italgas RAB	5,651	1.61	End 2015E RAB
Stogit RAB	4,196	1.20	End 2015E RAB
Associates and other activities	1,693	0.48	15x P/E multiple to associate income (2015E) + €100mn non-core activities
LNG terminal	108	0.03	In line with YE12 RAB value
Snam RG incentives on development capex	672	0.19	Value of incentives from €8.3bn of expansion capex (2006-15)
Stogit and Italgas incentives	353	0.10	Assuming €1bn of incentive capex 2009-15
Return spread differential	12	0.00	Assumed spread to end of next reg periods
Opex outperformance	-204	-0.06	After-tax
Tax liability (includes Robin Hood tax)	-439	-0.13	NPV deferred tax liability (€70mn pa repayments), Robin Hood tax (to 2017)
Enterprise value	27,282	7.80	
Less net debt	-13,728	-3.92	End 2015E net debt
Less other provisions (excludes Stogit dismantling fund)	-708	-0.20	End 2015E
Equity value of Snam RG - RAB-based	12,845	3.67	
Number of shares at the end of 2015, net of Treasury	3,500	mn	Net of 195.4mn treasury shares

Source: Company data, Goldman Sachs Global Investment Research.

Appendix: Price target methodologies and risks

Exhibit 8: 12 month price target methodology and risks

Company	Currency	Price Target [12 months]	Rating	Price target methodology	Risks to Price Target
A2A	EUR	1.05	Buy	50% SOTP, 50% P/E relative value	Lower Italian power prices and spreads, later and lower contribution from capacity payments, lower value creation from M&A, higher Italian government bond yields.
Enel	EUR	4.40	Neutral	50% SOTP, 50% P/E relative value	Lower/higher than expected political intervention risks in Spain, higher/lower commodity/power prices, lower/higher country risks premia, stronger/weaker FX vs. EUR
Hera	EUR	2.95	Buy**	50% SOTP and 50% P/E relative value	Lower economic growth, execution of M&A activity, working capital deterioration, dilution from potential equity raises, a high correlation with Italian government bond yields and regulatory risks
Snam	EUR	4.1	Sell	50% RAV-based SOTP, 50% P/E relative value	Lower interest rates; better cost cutting; faster capex delivery; regulatory returns better than forecast.
Terna	EUR	3.75	Sell**	50% RAV based-SOTP, 50% P/E relative value	Lower interest rates; better cost cutting; faster capex delivery; regulatory returns better than forecast.

** Denotes Conviction list membership

Source: Goldman Sachs Global Investment Research.

Disclosure Appendix

Reg AC

We, Fred Barasi, CFA, Dario Carradori and Deborah Wilkens, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

Growth is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

Quantum

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Disclosures

Coverage group(s) of stocks by primary analyst(s)

Fred Barasi, CFA: Europe-Utilities. Dario Carradori: Europe-Utilities. Deborah Wilkens: Europe-Utilities.

Europe-Utilities: A2a SpA, Acciona SA, Centrica, CEZ, Drax Group, E.ON, EDF, EDP Renovaveis SA, Elia System Operator SA, Enagas, Endesa SA, Enel Green Power, Enel SpA, Energias de Portugal, EVN AG, Fortum, Gamesa Corporacion Tecnologica SA, Gas Natural, GDF SUEZ, Hera SpA, Iberdrola SA, National Grid, Nordex SE, Pennon, PGE, Public Power Corp., Red Electrica de Espana, REN, RWE, Severn Trent, Snam SpA, SSE Plc, Suez Environnement, Tauron Polska Energia SA, Terna, United Utilities, Veolia Environnement, Verbund, Vestas Wind Systems A/S.

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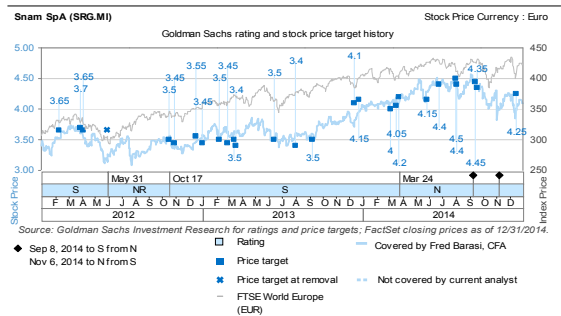
Distribution of ratings/investment banking relationships

Goldman Sachs Investment Research global coverage universe

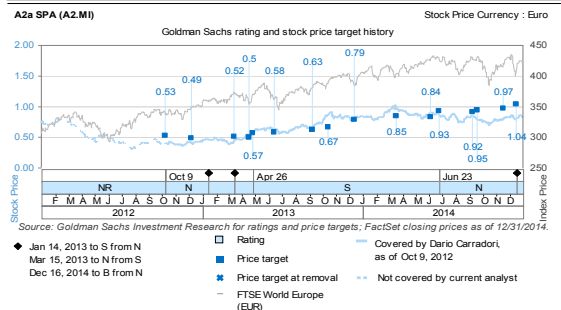
	Rating Distribution			Investment Banking Relationships		
	Buy	Hold	Sell	Buy	Hold	Sell
Global	33%	54%	13%	44%	38%	32%

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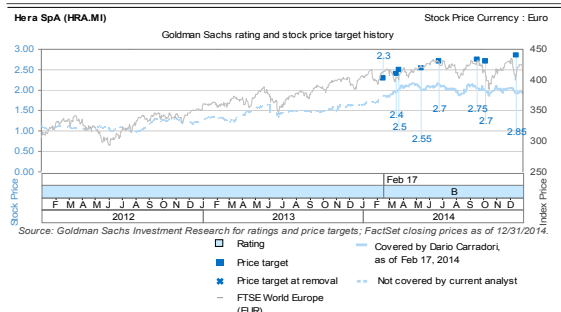
Price target and rating history chart(s)



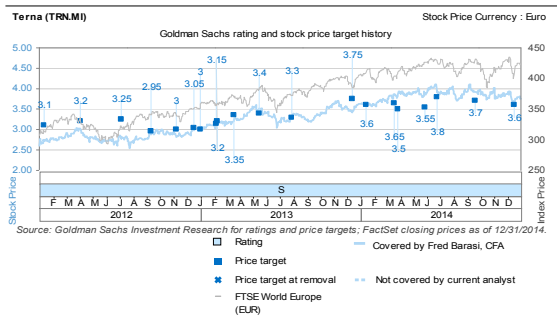
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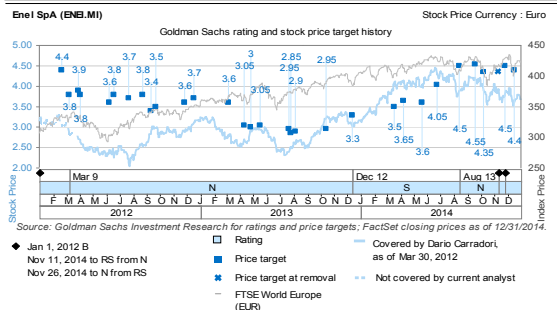
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