Fitch Affirms Iren S.p.A. at 'BBB'; Outlook Stable

Fitch Ratings has affirmed Italian utility Iren S.p.A.'s Long-Term Issuer Default Rating (IDR) and senior unsecured rating at 'BBB'. The Outlook on the IDR is Stable.

The affirmation reflects the updated business plan up to 2023, which largely follows the same strategic pattern as the previous one, the predominance of regulated and quasi-regulated activities in the business mix (around 70%) and Iren's positive record in 2015-2018. Fitch considers Iren fairly placed for a 'BBB' rating, as we expect funds from operations (FFO) net adjusted leverage to remain at 4.7x on average across the business plan, which is consistent with the company's target financial policy, and strong coverage metrics for the rating.

KEY RATING DRIVERS

Updated Business Plan: The business plan update (September 2018) confirms the focus on customers, operational efficiency, together with increasing investments and growth mainly in networks and waste segments. Management expects EBITDA growth at a CAGR of 3.7% to EUR1.020 million in 2023, mainly driven by synergies (EUR 65 million) and organic growth (EUR120 million). Average annual capex is around EUR500 million (EUR415 million in the previous plan), largely related to regulated and quasi-regulated activities. Dividends will rise to around EUR160 million in 2023 from EUR80 million in 2017. Iren expects to deleverage to 2.3x net debt/EBITDA in 2023 (2017: 2.9x, based on the company's definition), compared with target leverage of up to 3.0x.

External Growth, Limited Headroom on Leverage: The business plan does not include non organic growth. However, management has stated that it targets an additional annual EBITDA of around EUR100 million deriving from M&A. Iren has also identified organic growth capex of around EUR1 billion not included in the plan. The rating case follows broadly the same approach, with the only difference being the inclusion of small acquisitions realised in the second half of 2018 and EUR100 million cumulative additional capex in 2022-2023. Taking into account a slightly lower EBITDA deriving from more conservative assumptions mainly for the electricity price, we expect average FFO net adjusted leverage of 4.9x in 2018-2021 and 4.7x for 2018-2023.

We believe that the company has limited room for sizeable non organic growth in the first part of the plan. However, we take into account management’s historical financial discipline and believe that Iren will pursue additional growth only if consistent with its target leverage. This in turn is consistent with our negative rating guideline based on leverage.

Solid Business Mix: Overall, we estimate regulated activities (electricity, gas and water distribution, waste collection) to contribute around 49% of EBITDA throughout the plan, with quasi-regulated activities (district heating, waste-to-energy, incentives) representing an additional 23%. We consider the current regulatory framework mature and transparent, with tariffs set by the authority to cover depreciation and operating costs, and to ensure a return on regulatory asset base (RAB). Fitch also believes that, based on the current consultation document published from the regulator on the interim revision on electricity and gas WACC, some upside could arise based on the increased country risk premium.

Potential Challenges for Water Activities: Historically there has been constant political focus on water activities in Italy (i.e. referendum in 2011). We deem the recent proposal of the possible nationalisation of the water service formalised in the “Daga” project law as credit negative for all the sector's companies as it would undermine the long-term regulatory framework defined by the independent authority, ARERA. Fitch expects the related approval process to be uncertain (on timing and contents) and complex, mainly in light of high associated economic costs (reimbursement of net invested capital and debt to concessionaire) and required political agreement. Consequently, we have not inferred any conclusions on possible debt capacity reduction.

Iren is exposed to the potential changes, as almost 25% of its expected 2018-2023 EBITDA and more than 30% of capex is related to the water regulated network. On the other hand, we believe that the potential impact of an eventual nationalisation will only occur in the next two to three years and should be accompanied by adequate compensation.

Concession Renewal Risk: Apart from water, Iren continues to have concession renewal risk in gas distribution and waste collection (in some districts) and around half of the installed hydro capacity. We consider this risk to be limited, as the company is the incumbent in four of the five gas districts where it operates. Moreover, in case of concession loss the outgoing operators are entitled to a reimbursement value broadly aligned with the value of the RAB for gas and of the net invested capital for water. Currently there is no clear framework for the tenders related to hydro capacity.

Stable Merchant Activities: The forward 2019 for electricity price in Italy is currently around EUR65/MWh, compared with around EUR60/MWh in the first 10 months of 2018 and EUR53/MWh in 2017. The increase mainly reflects the cost trend of CCGTs, which set the price for a sizeable amount of time in Italy. Iren would benefit from high prices for its hydro production (around 1.3TWh per year). However, the bulk of its generation comes from CCGTs and cogeneration plants (around 7TWh together per year), for which we do not forecast large variation of the unitary spreads across the plan. Supply could suffer for some quarters until the company adjusts upwards the prices applied to customers to the level observed in the market.

Positive Current Trading: Iren has reported a solid recurring operating performance, with 2.5% EBITDA growth in 2017 and 7% in the first nine months of 2018. In the nine months to September 2018, growth was supported by cost savings (EUR15 million) and the consolidation of ACAM and Recos (EUR20 million in total), while organic growth and higher hydro volumes (EUR24 million in total) more than offset the negative effect of the reduction in spark spreads. In the same period, free cash flow was positive by around EUR160 million, but after acquisitions (and the related debt consolidation) group net debt was broadly in line with FYE 2017 at around EUR2.970 million. We expect the group's FFO net adjusted leverage to reach 4.8x in 2018.

DERIVATION SUMMARY

Iren has a comparable business profile with other Italian multi-utilities rated by Fitch such as Acea S.p.A. (BBB+/Stable), Alperia S.p.A. (BBB/Stable) as well as with international peers such as Energias de Portugal (EDP, BBB-/Stable). For Acea the rating differential derives from the higher contribution of fully regulated activities (around 75% vs. 45%) and slightly lower leverage. Alperia has the same rating with a lower debt capacity (FFO net adjusted leverage between 3.0x and 3.7x), due to the lower contribution of regulated and quasi-regulated activities (40-45%), partially offset by a 100% fuel cost-free asset base. EDP has a lower rating, notwithstanding a broadly similar leverage metrics and larger size, due to its lower share of regulated activities in the overall business.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer
- EBITDA growing at a CAGR of around 2.7% in 2017-2023 at the current perimeter, mainly driven by networks, environment and market divisions, with a slightly negative trend for generation and district heating (due to green certificates expiry)
- Annual capex of around EUR480 million on average (excluding those related to energy efficiency activities), in line with the company's business plan
- Acquisition of San Germano (waste management) for an overall additional cash out of EUR25 million in 2018 and related EBITDA contribution of EUR8 million-EUR7 million form 2019 onwards.
-Additional organic investments (not included in the company's business plan) of EUR50 million per year in 2022-2023 with an EBITDA contribution of EUR5 million in 2022 and EUR10 million in 2023
- Dividends to shareholders of around EUR125 million on average for 2018-2023

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action
- FFO adjusted net leverage declining below 4.3x, FFO interest coverage sustained above 5.0x, assuming unchanged business risk profile and positive free cash flow.

Developments That May, Individually or Collectively, Lead to Negative Rating Action
- FFO adjusted net leverage above 5.0x, FFO interest coverage below 4.0x over a sustained period, for instance as a result of lower than expected operating cash flows and lack of capex and dividend adjustment. Growing exposure to

unregulated activities, upward revision to Iren's dividend policy or material debt funded acquisitions beyond those already considered.
- Material changes in water regulation could lead to a revision of the rating guidelines

LIQUIDITY

Healthy Liquidity Profile: At 30 September 2018, Iren had readily available cash of EUR536 million and undrawn committed lines of EUR235 million, compared with short-term debt of EUR272 million and expected negative free cash flow for the following 12 months of around EUR125 million. At that time the liquidity score was around 1.9x.

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