Iren S.p.A. (/gws/en/esp/issr/96175977)

FitchRatings

Fitch Upgrades Iren to 'BBB'; Outlook Stable

Fitch Ratings-Milan/London-20 December 2017: Fitch Ratings has upgraded Italian utility Iren S.p.A.'s Long-Term Issuer Default Rating (IDR) to 'BBB' from 'BBB-' and affirmed the senior unsecured rating at 'BBB'. The Outlook on the IDR is Stable.

The upgrade mainly reflects the company's sizeable outperformance of our expectations, the successful integration of some medium sized companies, the faster than expected achievement of synergies and the structurally positive free cash flows (FCF; cumulative around EUR320 million expected in the rating case in 2017-2022). These factors have driven a sharp reduction of funds from operations (FFO) net adjusted leverage to an expected 4.7x for 2017 from 6.2x in 2014 (pro-forma).

We expect Iren's leverage to remain consistent with the 'BBB' rating across the business plan (average 2017-2022 of 4.7x), with coverage metrics strong for the rating, also supported by company's target financial policy.

KEY RATING DRIVERS

Outperformance Drives Upgrade: Iren achieved a sizeable outperformance in 2016-2017, with EBITDA in the range of EUR800-EUR820 million in both years (based on our definition and current estimate) compared with our expectations of around EUR750 million. The main drivers were the faster than expected delivery of synergies, the successful integration of medium sized companies and benefits from a rebalanced energy market. Moreover Iren reduced its cost of debt, further increasing the outperformance at FFO level. Consequently the company matched our positive leverage guideline of 5.0x in 2016, while for the business plan horizon we expect a further reduction, consistent with an upgrade.

Updated Business Plan: The business plan update (November 2017) confirms the focus mainly on customers, operational efficiency and development of selected activities. Management expects EBITDA growth at a CAGR of 3.3% to EUR950 million in 2022, mainly driven by cost savings (EUR80 million) and organic growth (EUR110 million), particularly related to networks and environment. Average annual capex is EUR415 million (EUR370 million in the previous plan), largely related to regulated and quasi-regulated activities. Dividends rise from EUR70 million in 2016 to around EUR130 million in 2022. Iren expects to deleverage to 2.3x net debt/EBITDA in 2022 (based on the company's definition), compared with target leverage of up to 3.0x.

External Growth: The business plan does not include external growth, but management stated that the delivery of the plan would leave room for additional investments. The rating case includes the potential acquisition of ACAM S.p.A. (currently under discussion) from 2018, contributing EBITDA of around EUR30 million (mostly regulated) and additional debt of around EUR145 million. Coupled with the prudent assumptions in the rating case, this would have room for additional external growth only towards the end of the plan, to comply with the company's financial policy.

Regulated Activities, EBITDA Mix: Iren operates in electricity, gas and water distribution. We consider the 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). We estimate regulated activities (including waste collection) to contribute around 47% of EBITDA throughout the plan, with quasi-regulated activities (district heating, waste-to-energy) representing an additional 21%.

Concession Renewal Risk: Iren has concession renewal risk in gas distribution, water distribution and waste collection (in some districts) and around half of the installed hydro capacity. We consider this risk rather limited, as the company is the incumbent in four of five gas districts where it operates and two water districts where it intends to bid. 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.

Merchant Activities Outlook Improving: Iren has moderate exposure to merchant risk mainly through its 'Generation & District Heating' and the 'Market' divisions (29% and 17% of EBITDA 2016, respectively). Since autumn 2016 electricity prices and spark spreads in Italy recovered substantially, also driven by exogenous factors. The forward price for 2018 (around 53EUR/MWh for baseload) is quite high if compared with the past few years. We currently see slightly better fundamentals for the Italian electricity market, mainly due to some recovery for gas (+8.1% in 9M17) and electricity demand (+1.6% in the 11 months to November 2017) and sizeable reduction of overcapacity.

Senior Unsecured Rating: Based on our methodology, the senior unsecured rating of Iren benefited from a one-notch uplift to 'BBB' compared with the IDR, due to the weight of regulated and quasi-regulated activities on EBITDA. However, Fitch does not use the uplift when it would cause the senior unsecured rating to be higher than the sovereign rating (BBB/Stable). Therefore the IDR and senior unsecured rating are now at the same level.

DERIVATION SUMMARY

Iren has a comparable business profile to other Italian multi-utilities rated by Fitch such as Acea S.p.A. (BBB+/Stable), Alperia S.p.A. (BBB/Stable) and Linea Group Holding S.p.A. (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. Linea has a lower rating, due to its smaller size and a less solid business mix with high exposure to waste and lower weight of regulated activities. For Linea the acquisition of a majority stake by A2A is credit positive.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- EBITDA growing at a CAGR of around 2% in 2016-2022 at current perimeter, mainly driven by networks and environment divisions, with flat trend for market and reduction for generation and district heating (due to green certificates expiry)
- Acquisition of ACAM S.p.A., consolidated from 2018 with a EBITDA contribution of EUR30 million (water distribution and waste collection) and additional debt of EUR145 million
- Annual capex of EUR415 million on average (including cash-outs for gas tenders), in line with the company's business plan
- Dividends to shareholders of around EUR100 million on average for 2017-2022

RATING SENSITIVITIES
Future 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 flows.

Future 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.

LIQUIDITY
Healthy Liquidity Profile: At 30 September 2017 Iren had readily available cash of EUR128 million and undrawn committed lines of EUR425 million, compared with short-term debt of EUR281 million and expected positive free cash flow for the following 12 months of around EUR75 million. After that date Iren issued a EUR500 million 10-year Green Bond under its EUR2.0 billion EMTN programme and repaid debt through a liability management exercise for EUR342 million.

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Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable Criteria
Corporate Rating Criteria (pub. 07 Aug 2017) (https://www.fitchratings.com/site/re/901296)
Non-Financial Corporates Notching and Recovery Ratings Criteria (pub. 16 Jun 2017) (https://www.fitchratings.com/site/re/899659)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1034323)
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