FitchRatings

Fitch Assigns Iren First-Time 'BBB-' Rating; Outlook Stable

Fitch Ratings-Milan/London-15 October 2015: Fitch Ratings has assigned Italy-based utilities group Iren SpA (Iren) a Long-term Issuer Default Rating (IDR) of 'BBB-' with Stable Outlook.

It has also assigned Iren's outstanding senior unsecured seven-year EUR300m notes maturing in July 2021 a rating of 'BBB'. The company's EMTN programme and the upcoming senior unsecured bond under the same programme have been assigned expected ratings of 'BBB(EXP)'. The final rating of the upcoming bond is contingent upon the receipt of final documentation conforming materially to information already received.

The ratings mainly reflect Iren's robust business profile, with regulated activities representing around half its consolidated EBITDA in a regulatory environment which we view as generally supportive and transparent. The ratings also factor in a substantial contribution from quasi-regulated activities and the satisfactory visibility and stability of results.

The ratings also take into account the leveraged financial profile and our forecasts for the group, including Iren's external growth plans (mainly in waste-to-energy
(WTE) through the acquisition of Trattamento Rifiuti Metropolitani S.p.A. (TRM)) and internal development, mainly in district heating and waste.

Fitch expects funds from operations (FFO) adjusted net leverage to average 5.3x and FFO interest coverage of 4.6x for 2015-2020. In light of Iren's business profile, we see these ratios as consistent with the 'BBB-' rating.

The senior unsecured rating of 'BBB' is notched up once from the IDR given the expected contribution of regulated and quasi-regulated activities to group EBITDA across the business plan (respectively 50% and 23%), which strengthens the recovery prospect of the senior unsecured creditors.

KEY RATING DRIVERS

Regional Multi-utility

Iren is the fourth largest Italian multi-utility by revenues (EUR2.9bn in 2014 adjusted for 12 months of district heating activity in Turin), with a strong geographical focus on the wealthy north-west part of Italy. Local public shareholders hold more than 60% of the share capital (the main ones being the municipalities of Genoa and Turin, BBB/Stable), which contribute to the group's focus on the reference geographical area.

The group is mainly active in regulated (electricity, gas, water networks and urban waste collection) and quasi-regulated businesses (WTE and district heating), representing respectively 51% and 21% of consolidated EBITDA in 2014 (EUR638m restated). The unregulated business includes electricity generation (installed capacity of 2.7GW, 22% hydro, 47% cogeneration and 31% CCGT) and supply (around 700,000 customers both for gas and electricity).

Supportive Strategy

The 2015-2020 business plan presented in June 2015 is strongly focused on the pursuit of operational efficiency and continuous deleverage. The target for annual efficiencies has been set at EUR60m by 2018 and EUR75m by 2020. Fitch views this goal as quite challenging, although we acknowledge that there is substantial room for improvement and that some savings (pre-retirement scheme worth EUR25m) have been already secured.

Iren plans to consolidate additional assets in 2015-2016, mainly in the water, district heating and above all WTE businesses, with an additional EBITDA of around EUR80m and net debt of around EUR400m. The most important transaction is related to a WTE plant in Turin. We view the identified assets compatible with the group's strategy, although these acquisitions would substantially slow down deleveraging.

Expected capex amounts to around EUR1.8bn, with development projects mainly focused on district heating and waste treatment, where we also see growth potential. Management has defined an average dividend payout of 50% and expects net leverage (as defined by the company) to decrease to 2.3x in 2020 from 3.7x in 2014.

Mature Framework; Concession Renewal Risk

The Italian Autorita' per l'Energia Elettrica, il Gas ed il Sistema Idrico (AEEGSI) is undertaking a revision of the drivers of the weighted average cost of capital (WACC) used to remunerate the regulatory asset base (RAB) for all the regulated activities of gas and electricity (effective from 2016). Fitch is assuming an outcome of around 5% for Iren's regulated activities, which would lead to a drop of EBITDA of around EUR20m year-on-year in 2016. Moreover a new regulatory period will start for electricity and water in 2016. However, we do not foresee changes which would significantly impact Iren's financials, apart from the WACC revision.

Iren faces concession renewal risk mainly in gas and water distribution and around half of the installed hydro capacity. We consider this risk rather limited, as the company is the incumbent in the four relevant gas 'Ambiti Territoriali Minimi' (ATEM, pools of municipalities) and the two water 'Ambiti Territoriali Ottimali' (ATO) expected to be tendered from 2016. Moreover, in case of concessions loss the outgoing operators are entitled to receive a reimbursement value broadly aligned to the RAB for gas and the net invested capital for water (for hydro capacity the mechanism is not clear and tenders could be postponed beyond the business plan horizon).

The tenders could bring some volatility to the credit ratios and reduce rating headroom in single years, but we expect the overall financial impact to be fairly limited for Iren.

Challenging Scenario for Generation

Electricity demand in Italy is showing the first signs of stabilisation in 2015, after having declined for the past three consecutive years. Iren's generation business is still suffering from the system's heavy overcapacity and squeezed margins, notwithstanding the capacity shutdowns and mothballing implemented by the main players.

Fitch expects electricity demand to be sluggish and the overall scenario for generation to remain unfavorable across Iren's business plan horizon (although slightly improving over the medium term), which leads us to expect negative EBITDA contribution from Iren's cogeneration plants and CCGT. However the cogeneration plants are important to the group's business model, as they provide almost all the heat needed by the growing district heating network.

Positive Start into 2015

In 2014 the group's pro-forma EBITDA (EUR638m) decreased 2% year-on-year in a challenging market and climate (an extraordinarily mild heating season), on the back of the positive contribution from networks, waste electricity and supply. Iren reported slightly negative free cash flow (FCF) of EUR29m and a rather aggressive pro-forma FFO net adjusted leverage of 6.2x.

Management estimates an EBITDA of EUR650m-660m for 2015, with the consolidation of some assets and a positive trend in the supply business offsetting the expiry of green certificates for cogeneration and a still difficult environment for generation. In 1H15 Iren achieved an EBITDA growth of 2.6% (excluding extraordinary gains). Fitch believes that management's target for the full year is reasonable and forecasts broadly neutral FCF, with Fitch-adjusted net debt estimated at EUR2.9bn in 2015 and an FFO adjusted net leverage of 5.9x.

Deleveraging Factored into Ratings

Fitch is factoring in its forecasts some conservative components, mainly related to the WACC assumed for regulated businesses from 2016, a prolonged unfavorable scenario in generation, more limited growth in the waste business and a cost of debt at 2014 levels, notwithstanding some upside potential. We are also including the acquisitions for which management has expressly announced its interest in (the largest one being TRM). Based on these assumptions, FFO net adjusted leverage for the period 2015-2020 is expected to average 5.3x, with an FFO interest coverage of 4.6x.

Although FFO adjusted net leverage (2014 and most likely 2015) falls outside of the rating guidelines, we expect the ratio to reduce to 5.6x in 2016 and further thereafter. We believe that development capex (higher in the first part of the business plan) and dividends offer some flexibility for the group in case of negative unforeseen events, supporting our confidence in Iren's deleveraging.

Evolving Debt Structure

Since October 2013 Iren has diversified its funding sources through various private placements and a senior unsecured seven-year EUR300m (3%) bond issued in July 2014. At end-June 2015 these instruments represented around 30% of the group's total debt of EUR2.7bn, which would rise up to 40% with the upcoming issue of another bond. Current low interest rates have enabled Iren reduce the cost of debt to 3.4% in 1H15 from 3.9% in 2013, after which the company expects to be broadly flat.

Reduced Tax Burden
Fitch also considers that future cash flows will benefit from the abolition of the so-called Robin Hood Tax. According to this change, Iren's tax rate will decrease from 2015 due to the cancellation of the 6.5% tax surcharge on the income of Italian energy companies. Iren will not be able to claw back the amounts already paid but will nevertheless benefit from a positive impact of around EUR20m annually.

KEY ASSUMPTIONS
Fitch's key assumptions within our rating case for the issuer include:
- reduction of the WACC for all the regulated businesses to around 5% from 2016;
- electricity price below EUR55/MWh for the whole period and negligible spark spread until 2017, with slow growth thereafter;
- operating efficiencies reaching EUR55m in 2020;
- cost of debt based on 1H15 levels, higher cost for new debt from 2016;
- tax rate benefitting from Robin Hood Tax's cancellation;
- additional EBITDA and net debt from acquisitions of respectively around EUR80m and EUR400m (acquisition of TRM assumed to occur at the beginning of 2016);
- dividend pay-out in the range of 50-60%.

RATING SENSITIVITIES
Positive: An upgrade is not likely in the next 24 months considering that gradual deleveraging is already factored into the current ratings. However, future developments that could lead to a positive rating action include:
- FFO adjusted net leverage declining below 5.0x, FFO interest coverage above 4.0x on a sustained basis, assuming unchanged business risk profile and positive FCF.

Negative: Future developments that could lead to a negative rating action include:
- FFO adjusted net leverage above 5.75x, FFO interest coverage below 3.0x 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
The company's liquidity profile is adequate. Cash at end-June 2015 amounted to EUR30m, which together with committed undrawn EIB lines of EUR150m and the EUR300m committed revolving lines recently signed (maturity 2018), are sufficient to cover short-term debt maturities of EUR403m until end-June 2016. Fitch forecasts broadly neutral FCF until end-June 2016.

The expected bond issue would further strengthen Iren's liquidity profile (the committed lines and the upcoming bond would cover maturities for 2016 and 2017). In addition, Iren is negotiating a new EIB line of up to EUR140m.

Debt is raised at the level of the parent Iren SpA (97%), with an average maturity of five years for long-term debt and a fixed or swapped portion of around 75%. EIB loans represent more than 30% of total debt. The acquisition of TRM would imply the consolidation of its project financing of around EUR330m into Iren's total debt (with the related typical provisions).

Fitch will publish a full rating report and Ratings Navigator for Iren shortly.

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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 Methodology - Including Short-Term Ratings and Parent and Subsidiary Linkage (pub. 17 Aug 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869362)

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