

# TERNA SpA (TRN.MI)

## Diminishing Expectations

- **Terna: no growth in sight.** With Terna's capex cycle coming to an end, declining inflation and regulatory pressure, we believe that the group's EPS will peak in 2015 and then growth will turn negative. Terna is looking at acquisitions to boost growth but with an already geared balance sheet (net debt/RAB c.60% in 2017) we believe room for manoeuvre is limited. SELL.
- **Valuation does not look compelling.** We expect the group's real post-tax return on RAB to be in the region of 4.5% (average 2014-18E), of which 57bps is derived from capex incentives. With inflation remaining subdued (0.6% average 2014-18E on Citi economists' estimates) and incentives on development capex gradually fading away, we believe the premium to the group's WACC (4.4% in our estimates) is not enough to justify the hefty 25% premium to equity RAB currently embedded in the group's share price.
- **Realistic view.** Terna is not in denial about the limited growth prospects of its core business and we believe the group's plan is based on realistic assumptions compared to peers. Management is committed to finding new growth opportunities and indicated that some €400mn of potential additional investments have been identified and there is potential for an additional €900mn to follow. While we recognize the group's good track record in creating shareholder value, we believe that, in light of the competition deploying capital especially in emerging markets, it would be inappropriate to factor any potential value creation from these new opportunities into our SOTP.
- **Target price increased to €3.15.** We update our estimates to reflect a capex plan more concentrate on 2014 and 2015 than expected, and the solid delivery on cost containment that emerged from 2013 results (EPS +1.5% avg 2014-16E). We also increase our target price to €3.15 (from €3) to reflect the recent decline in Italian real rates (-47 bps YTD as bond yields have declined faster than inflation), which should support Terna's valuation as allowed return is set until December 2015.

- Target Price Change
- Estimate Change

|                              |               |
|------------------------------|---------------|
| <b>Sell</b>                  | <b>3</b>      |
| Price (25 Mar 14)            | €3.76         |
| Target price                 | €3.15         |
|                              | from €3.00    |
| Expected share price return  | -16.3%        |
| Expected dividend yield      | 5.3%          |
| <b>Expected total return</b> | <b>-11.0%</b> |
| Market Cap                   | €7,566M       |
|                              | US\$10,461M   |

## Price Performance (RIC: TRN.MI, BB: TRN IM)



## TERNA SpA (EUR)

| Year to 31 Dec        | 2012A   | 2013A   | 2014E   | 2015E   | 2016E   |
|-----------------------|---------|---------|---------|---------|---------|
| Sales (€M)            | 1,806.0 | 1,889.0 | 1,893.5 | 1,988.6 | 1,995.9 |
| Net Income (€M)       | 464.6   | 513.7   | 514.5   | 534.1   | 500.7   |
| Diluted EPS (€)       | 0.23    | 0.26    | 0.26    | 0.27    | 0.25    |
| Diluted EPS (Old) (€) | 0.23    | 0.25    | 0.25    | 0.26    | 0.25    |
| PE (x)                | 16.3    | 14.7    | 14.7    | 14.1    | 15.1    |
| EV/EBITDA (x)         | 9.6     | 9.5     | 10.0    | 9.7     | 9.8     |
| DPS (€)               | 0.20    | 0.20    | 0.20    | 0.20    | 0.20    |
| Net Div Yield (%)     | 5.3     | 5.3     | 5.3     | 5.3     | 5.3     |

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## See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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| TRN.MI: Fiscal year end 31-Dec |               |               |               |               |               | Price: €3.76; TP: €3.15; Market Cap: €7,558m; Recomm: Sell |               |               |               |              |              |
|--------------------------------|---------------|---------------|---------------|---------------|---------------|--|---------------|---------------|---------------|--------------|--------------|
| Profit & Loss (€m)             | 2012          | 2013          | 2014E         | 2015E         | 2016E         | Valuation ratios   | 2012          | 2013          | 2014E         | 2015E        | 2016E        |
| Sales revenue                  | 1,806         | 1,889         | 1,893         | 1,989         | 1,996         | PE (x)   | 16.3          | 14.7          | 14.7          | 14.1         | 15.1         |
| Cost of sales                  | -199          | -204          | -206          | -209          | -211          | PB (x)   | 2.7           | 2.6           | 2.5           | 2.4          | 2.3          |
| Gross profit                   | 1,607         | 1,685         | 1,687         | 1,780         | 1,785         | EV/EBITDA (x)  | 9.6           | 9.5           | 10.0          | 9.7          | 9.8          |
| Gross Margin (%)               | 89.0          | 89.2          | 89.1          | 89.5          | 89.4          | FCF yield (%)  | -0.1          | -1.3          | -0.2          | 4.2          | 6.6          |
| <b>EBITDA (Adj)</b>            | <b>1,390</b>  | <b>1,481</b>  | <b>1,481</b>  | <b>1,572</b>  | <b>1,575</b>  | Dividend yield (%)   | 5.3           | 5.3           | 5.3           | 5.3          | 5.3          |
| EBITDA Margin (Adj) (%)        | 77.0          | 78.4          | 78.2          | 79.1          | 78.9          | Payout ratio (%)   | 86            | 78            | 78            | 75           | 80           |
| Depreciation                   | -421          | -443          | -472          | -499          | -518          | ROE (%)  | 16.8          | 17.9          | 17.2          | 17.1         | 15.5         |
| Amortisation                   | 0             | 0             | 0             | 0             | 0             | <b>Cashflow (€m)</b>                                       | <b>2012</b>   | <b>2013</b>   | <b>2014E</b>  | <b>2015E</b> | <b>2016E</b> |
| <b>EBIT (Adj)</b>              | <b>969</b>    | <b>1,038</b>  | <b>1,009</b>  | <b>1,074</b>  | <b>1,057</b>  | EBITDA   | 1,390         | 1,481         | 1,481         | 1,572        | 1,575        |
| EBIT Margin (Adj) (%)          | 53.7          | 54.9          | 53.3          | 54.0          | 53.0          | Working capital  | 131           | -55           | -50           | -57          | -48          |
| Net interest                   | -93           | -100          | -144          | -176          | -216          | Other  | -291          | -313          | -353          | -350         | -373         |
| Associates                     | 0             | 0             | 0             | 0             | 0             | <b>Operating cashflow</b>                                  | <b>1,230</b>  | <b>1,113</b>  | <b>1,078</b>  | <b>1,166</b> | <b>1,154</b> |
| Non-op/Except                  | 0             | 0             | 0             | 0             | 0             | Capex  | -1,235        | -1,212        | -1,097        | -851         | -656         |
| <b>Pre-tax profit</b>          | <b>877</b>    | <b>938</b>    | <b>865</b>    | <b>898</b>    | <b>842</b>    | Net acq/disposals  | 0             | 0             | 0             | 0            | 0            |
| Tax                            | -412          | -424          | -350          | -364          | -341          | Other  | 0             | 0             | 0             | 0            | 0            |
| Extraord./Min.Int./Pref.div.   | 0             | 0             | 0             | 0             | 0             | <b>Investing cashflow</b>                                  | <b>-1,235</b> | <b>-1,212</b> | <b>-1,097</b> | <b>-851</b>  | <b>-656</b>  |
| <b>Reported net profit</b>     | <b>465</b>    | <b>514</b>    | <b>515</b>    | <b>534</b>    | <b>501</b>    | Dividends paid   | -422          | -402          | -402          | -402         | -402         |
| Net Margin (%)                 | 25.7          | 27.2          | 27.2          | 26.9          | 25.1          | <b>Financing cashflow</b>                                  | <b>-422</b>   | <b>-402</b>   | <b>-402</b>   | <b>-402</b>  | <b>-402</b>  |
| Core NPAT                      | 465           | 514           | 515           | 534           | 501           | <b>Net change in cash</b>                                  | <b>-427</b>   | <b>-501</b>   | <b>-420</b>   | <b>-88</b>   | <b>96</b>    |
| <b>Per share data</b>          | <b>2012</b>   | <b>2013</b>   | <b>2014E</b>  | <b>2015E</b>  | <b>2016E</b>  | <b>Free cashflow to s/holders</b>                          | <b>-5</b>     | <b>-99</b>    | <b>-18</b>    | <b>314</b>   | <b>498</b>   |
| Reported EPS (€)               | 0.23          | 0.26          | 0.26          | 0.27          | 0.25          |  |               |               |               |              |              |
| Core EPS (€)                   | 0.23          | 0.26          | 0.26          | 0.27          | 0.25          |  |               |               |               |              |              |
| DPS (€)                        | 0.20          | 0.20          | 0.20          | 0.20          | 0.20          |  |               |               |               |              |              |
| CFPS (€)                       | 0.61          | 0.55          | 0.54          | 0.58          | 0.57          |  |               |               |               |              |              |
| FCFPS (€)                      | 0.00          | -0.05         | -0.01         | 0.16          | 0.25          |  |               |               |               |              |              |
| BVPS (€)                       | 1.39          | 1.46          | 1.52          | 1.59          | 1.64          |  |               |               |               |              |              |
| Wtd avg ord shares (m)         | 2,009         | 2,009         | 2,009         | 2,009         | 2,009         |  |               |               |               |              |              |
| Wtd avg diluted shares (m)     | 2,009         | 2,009         | 2,009         | 2,009         | 2,009         |  |               |               |               |              |              |
| <b>Growth rates</b>            | <b>2012</b>   | <b>2013</b>   | <b>2014E</b>  | <b>2015E</b>  | <b>2016E</b>  |  |               |               |               |              |              |
| Sales revenue (%)              | 10.4          | 4.6           | 0.2           | 5.0           | 0.4           |  |               |               |               |              |              |
| EBIT (Adj) (%)                 | 16.0          | 7.1           | -2.8          | 6.4           | -1.5          |  |               |               |               |              |              |
| Core NPAT (%)                  | 5.6           | 10.6          | 0.2           | 3.8           | -6.2          |  |               |               |               |              |              |
| Core EPS (%)                   | 5.6           | 10.6          | 0.2           | 3.8           | -6.2          |  |               |               |               |              |              |
| <b>Balance Sheet (€m)</b>      | <b>2012</b>   | <b>2013</b>   | <b>2014E</b>  | <b>2015E</b>  | <b>2016E</b>  |  |               |               |               |              |              |
| Cash & cash equiv.             | 151           | 151           | 151           | 151           | 151           |  |               |               |               |              |              |
| Accounts receivables           | 744           | 846           | 840           | 873           | 867           |  |               |               |               |              |              |
| Inventory                      | 7             | 8             | 8             | 8             | 8             |  |               |               |               |              |              |
| Net fixed & other tangibles    | 9,342         | 10,120        | 10,763        | 11,135        | 11,292        |  |               |               |               |              |              |
| Goodwill & intangibles         | 471           | 462           | 443           | 424           | 405           |  |               |               |               |              |              |
| Financial & other assets       | 215           | 312           | 312           | 317           | 317           |  |               |               |               |              |              |
| <b>Total assets</b>            | <b>10,929</b> | <b>11,898</b> | <b>12,516</b> | <b>12,907</b> | <b>13,040</b> |  |               |               |               |              |              |
| Accounts payable               | 1,152         | 780           | 774           | 805           | 800           |  |               |               |               |              |              |
| Short-term debt                | 960           | 1,377         | 1,973         | 2,279         | 2,393         |  |               |               |               |              |              |
| Long-term debt                 | 5,148         | 5,500         | 5,500         | 5,500         | 5,500         |  |               |               |               |              |              |
| Provisions & other liab        | 876           | 1,301         | 1,214         | 1,134         | 1,057         |  |               |               |               |              |              |
| <b>Total liabilities</b>       | <b>8,135</b>  | <b>8,958</b>  | <b>9,461</b>  | <b>9,718</b>  | <b>9,750</b>  |  |               |               |               |              |              |
| Shareholders' equity           | 2,794         | 2,940         | 3,055         | 3,189         | 3,291         |  |               |               |               |              |              |
| Minority interests             | 0             | 0             | 0             | 0             | 0             |  |               |               |               |              |              |
| <b>Total equity</b>            | <b>2,794</b>  | <b>2,941</b>  | <b>3,055</b>  | <b>3,189</b>  | <b>3,291</b>  |  |               |               |               |              |              |
| <b>Net debt</b>                | <b>5,957</b>  | <b>6,726</b>  | <b>7,323</b>  | <b>7,628</b>  | <b>7,743</b>  |  |               |               |               |              |              |
| Net debt to equity (%)         | 213.2         | 228.7         | 239.7         | 239.2         | 235.3         |  |               |               |               |              |              |

For definitions of the items in this table, please click [here](#).

## Earning peak to be reached in 2015

### Growth is coming to an end

Terna's organic growth prospects are coming to an end. With the completion of projects under construction, Italy offers no further growth opportunities and the capex plan is drying up. The group's earnings peak should be reached in 2015. Afterwards, amid declining RAB (due to low capex) and increasing regulatory pressure, earnings should begin to decline. The group is looking at international acquisitions for growth, but its balance sheet looks stretched (55-60% net debt /RAB in a low inflation environment) and we believe room for manoeuvre is limited in the shorter term.

### Nominal post tax-return only modestly above WACC and boosted by short-lived incentives

Terna's achieved real post-tax return on RAB is in the region of 4.5% (average 2014-18E) of which 57 basis points are explained by short-lived incentives (rapidly declining after 2017). Adding inflation, the overall return 2014-18E is in the region of 5.1% just above the group's cost of capital of 4.4%. Considering the declining trend of returns (expiry of incentives) this, in our view, does not justify the group's current 25% premium to equity RAB.

Valuation does not look compelling and declining Italian inflation will add pressure to the group's growth and debt levels. Also, approaching regulatory reviews (new regulatory periods starts in January 2016) represents a risk for the group as declining electricity demand and capex requirements suggest a claw back of some generous parameters embedded in the regulator's formula (cost of debt set at a premium to Italian 10-year bond yield, gearing assumptions materially below the group's actual leverage), which was justified in the past to support capex but is unlikely to be confirmed to sustain the group's acquisition strategy.

### Increasing target price to €3.15 on declining Italian real rates

We raise our estimates to reflect a capex plan more concentrated on 2014 and 2015 than expected and to include the solid delivery on cost containment in 2013 (EPS +1.5% avg 2014-16E). We also increase our target price to €3.15 per share (€3) to reflect the recent decline in Italian real rates (-47 bps YTD as bond yields have declined faster than inflation) which should support Terna's valuation as the allowed return is set until December 2015.

## Terna's New plan: Diminishing expectations

Terna is entering a new stage of its lifecycle. In light of declining inflation (Terna assumes an average 1.4% inflation 2014-20 vs. previous 2%) and declining allowed returns (cut to 6.3% from 7.4% in January 2014), the group targets are materially reduced. Terna expects the tariff RAB CAGR (2014-18) to reach 3.4% p.a (+7% 2012-17 in previous plan) and blended pretax return to reduce to 7.7% (average 2014-18) from 8.2% in 2013.

On Terna projections, the group's EBIT growth is in the region of 2.5% and net profit should remain broadly stable with financial costs increasing. Our estimates assume a lower average inflation (0.6% 2014-18E) and a reduction in allowed return to 5.6% in 2016 (new regulatory period), the company's forecast EBIT growth 2014-18 is only 0.6% and EPS growth is negative (-0.8% p.a.) despite the decline in the tax rate expected in 2014.

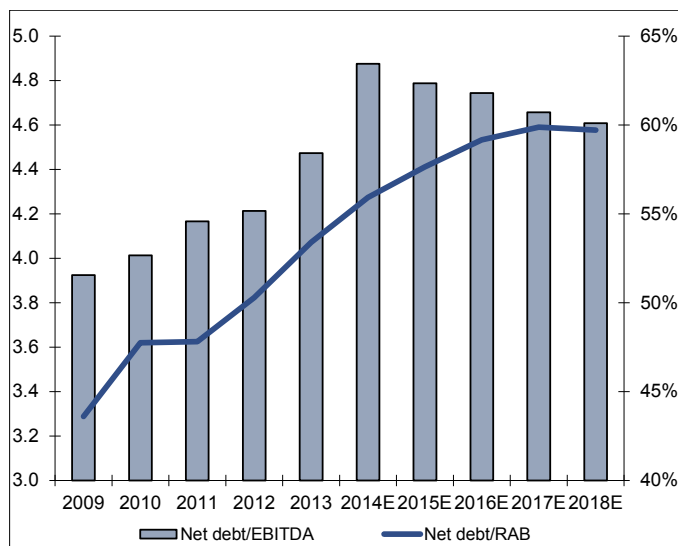
Figure 1. Terna plan: diminishing expectations

| Targets            | 2013-17 Plan           | 2014-18 Plan           | CITI Estimates 2014-18 |
|--------------------|------------------------|------------------------|------------------------|
| Regulated capex    | 4.1                    | 3.6                    | 3.6                    |
| Of which Batteries | 0.3                    | 0.2                    | 0.2                    |
| Tariff RAB Cagr*   | 7%                     | 3.4%                   | 2.1%                   |
| Blended Return     | 8.2%                   | 7.7%                   | 7.5%                   |
| EBITDA margin      | From 76% to 80%        | from 78% to 79%        | from 78% to 79%        |
| Debt target        | 6.8 bn                 | 7.2 bn                 | 7.4 bn                 |
| Net debt /RAB      | < 60%                  | < 60%                  | 60% from 2017          |
| Dividend           | 19 cents + extra value | 19 cents + extra value | 19 cents + extra value |

Source: Company Reports and Citi Research Estimates; \*Tariff RAB growth 2014-2018

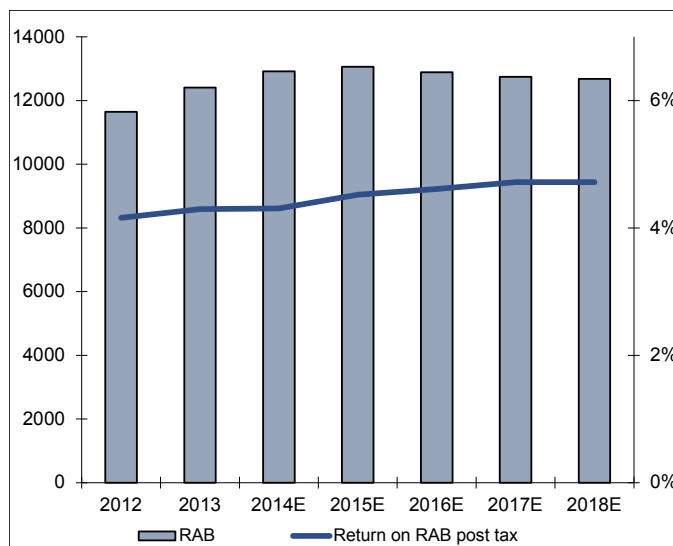
We expect the group's net debt/RAB to rapidly increase in the short term and to peak at 60% of RAB in 2017. In our estimates, the group's RAB should peak in 2015 and then rapidly decline on the back of low inflation and low capex. We expect achieved allowed return to remain broadly stable as the impact of the entrance into operation of high-return capex will be offset by the expected decline in allowed returns to be decided by the Italian regulator by January 2016.

Figure 2. Net debt/RAB to reach 60% in 2017



Source: Company Reports and Citi Research Estimates

Figure 3. RAB declines from 2016, post-tax return to remain stable



Source: Company Reports and Citi Research Estimates

As a consequence, we believe equity RAB is set to gradually decline also reflecting the reduction in the group's working capital following the decline in the capex plan.

Figure 4. Equity RAB set to decline

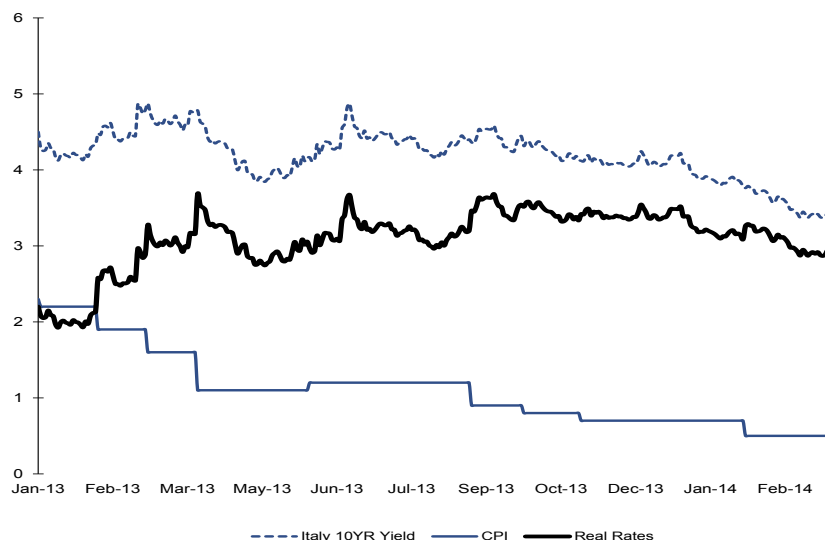
| Equity RAB                | 2012        | 2013        | 2014E       | 2015E       | 2016E       |
|---------------------------|-------------|-------------|-------------|-------------|-------------|
| Terna RAB                 | 11647       | 12408       | 12914       | 13059       | 12888       |
| + Other assets            | 427         | 435         | 444         | 453         | 462         |
| + Batteries               | 0           | 40          | 95          | 147         | 196         |
| - Net debt                | 5856        | 6625        | 7222        | 7527        | 7642        |
| - Provisions & Minorities | 134         | 114         | 112         | 110         | 108         |
| Equity RAB                | 6084        | 6144        | 6119        | 6022        | 5797        |
| <b>Equity per share</b>   | <b>3.03</b> | <b>3.06</b> | <b>3.05</b> | <b>3.00</b> | <b>2.89</b> |

Source: Company Reports and Citi Research Estimates

### Change in target price

We raise our target price to €3.15 from €3 to reflect the group's outperformance in costs containment in 2013 results as well as the decline in Italian real interests rates, which have fallen 47bps YTD. For 2014 and 2015, the group should benefit from interest rates declining faster than inflation. We expect this benefit to be clawed back in 2016 with the new regulatory period.

Figure 5. Italian real rates have declined by 47bps YTD



Source: DataStream, ISTAT

Figure 6. Target price increases to €3.15

| Valuation                                     | € million   |
|---|-------------|
| RAB 2014e                                     | 12,914      |
| development capex incentive                   | 352         |
| development capex incentive from 2012 on ward | 230         |
| Development capex 2004-2007                   | 32          |
| Fiscal liability                              | -147        |
| WACC outperformance                           | -58         |
| Services                                      | 266         |
| batteries NPV                                 | 163         |
| WC adjustments                                | -93         |
| EV  | 13,658      |
| Net debt 2014e                                | -7,222      |
| Provisions                                    | -112        |
| <b>Equity value</b>                           | <b>6325</b> |
| <b>Per share</b>                              | <b>3.15</b> |

Source: Citi Research

### Change in estimates

We update our estimates to reflect the better-than-expected FY2013 results, particularly with regard to cost cutting. We also reflect the acceleration of the company's capex plan that, according to management's plan, will be concentrated in 2014 and 2015. As a result, we raise our 2014-16 EPS estimates by an average 1.5%.

**Figure 7. EPS: upgraded 1.5% on average on increased cost cutting and acceleration of capex**

| EBITDA            | 2013  | 2014e | 2015e | 2016e |
|-------------------|-------|-------|-------|-------|
| Old               | 1,460 | 1,456 | 1,536 | 1,537 |
| New               | 1,481 | 1,481 | 1,572 | 1,575 |
| Ch%               | 1.4   | 1.7   | 2.4   | 2.5   |
| <b>Net profit</b> |       |       |       |       |
| Old               | 510   | 509   | 523   | 494   |
| New               | 514   | 515   | 534   | 501   |
| Ch%               | 0.6   | 1.1   | 2.0   | 1.4   |
| <b>Capex</b>      |       |       |       |       |
| Old               | 1146  | 991   | 770   | 634   |
| New               | 1212  | 1097  | 851   | 656   |
| <b>Net debt</b>   |       |       |       |       |
| Old               | 6586  | 7107  | 7356  | 7486  |
| New               | 6625  | 7222  | 7527  | 7642  |
| Ch%               | 0.6   | 1.6   | 2.3   | 2.1   |

Source: Company Reports and Citi Research Estimates

**Figure 8. Terna FY 2013 results: Slightly better than expected.**

| Terna                        | 2012A   | 2013A   | ch%   | 2013E   |
|------------------------------|---------|---------|-------|---------|
| Revenues                     | 1,806   | 1,889   | 4.6   | 1,883   |
| Operating cost               | (199)   | (202)   | 1.5   | (212)   |
| Cost of labour               | (217)   | (206)   | (5.0) | (210)   |
| EBITDA                       | 1,390   | 1,481   | 6.5   | 1,460   |
| Depreciation & ammortization | (421)   | (443)   | 5.3   | (435)   |
| EBIT                         | 969     | 1,038   | 7.1   | 1,025   |
| Net financial charges        | (93)    | (100)   | 8.3   | (106)   |
| Extraordinary components     | 0       | 0       |       | 0       |
| Pre-tax results              | 877     | 938     | 7.0   | 920     |
| Income taxes                 | (492)   | (464)   | (5.7) | (449)   |
| Discontinued                 | 80      | 40      |       | 40      |
| Net profit                   | 465     | 514     | 10.6  | 510     |
| Cash flow                    | 805     | 917     |       | 906     |
| Capex                        | (1,235) | (1,202) |       | (1,146) |
| Dividends                    | (422)   | (402)   |       | (402)   |
| Others                       | 119     | (83)    |       | (88)    |
| Free Cash Flow               | (732)   | (770)   |       | (731)   |
| Net Debt                     | (5,855) | (6,625) |       | (6,586) |

Source: Company Reports and Citi Research Estimates

Figure 9. TERNA Summary Financials and Key ratios

| € mn                                | 2012           | 2013           | 2014e          | 2015e          | 2016e          |
|-------------------------------------|----------------|----------------|----------------|----------------|----------------|
| Total revenues                      | 1,806          | 1,889          | 1,893          | 1,989          | 1,996          |
| Operating expenses                  | 416            | 408            | 412            | 416            | 420            |
| <b>EBITDA</b>                       | <b>1,390</b>   | <b>1,481</b>   | <b>1,481</b>   | <b>1,572</b>   | <b>1,575</b>   |
| Depreciation/amortization           | (421)          | (443)          | (472)          | (499)          | (518)          |
| EBIT                                | 969            | 1,038          | 1,009          | 1,074          | 1,057          |
| Net interest                        | (93)           | (100)          | (144)          | (176)          | (216)          |
| Pre-Tax income                      | 877            | 938            | 865            | 898            | 842            |
| Exceptional/others                  | 0              | 0              | 0              | 0              | 0              |
| Profit before tax                   | 877            | 938            | 865            | 898            | 842            |
| Tax                                 | (412)          | (424)          | (350)          | (364)          | (341)          |
| <b>Net income</b>                   | <b>465</b>     | <b>514</b>     | <b>515</b>     | <b>534</b>     | <b>501</b>     |
| <b>Balance sheet</b>                |                |                |                |                |                |
| Tangible assets                     | 9,342          | 10,120         | 10,763         | 11,135         | 11,292         |
| Intangible and financial assets     | 552            | 545            | 526            | 506            | 487            |
| Fixed assets                        | 9,894          | 10,665         | 11,289         | 11,641         | 11,780         |
| Other current assets                | 784            | 983            | 976            | 1,014          | 1,009          |
| Total assets                        | 10,678         | 11,647         | 12,265         | 12,656         | 12,790         |
| Current liabilities                 | (1,554)        | (1,629)        | (1,572)        | (1,554)        | (1,500)        |
| <b>Net financial debt</b>           | <b>(5,856)</b> | <b>(6,625)</b> | <b>(7,222)</b> | <b>(7,527)</b> | <b>(7,642)</b> |
| Provisions                          | (474)          | (453)          | (415)          | (385)          | (357)          |
| Net assets                          | 2,794          | 2,941          | 3,055          | 3,189          | 3,291          |
| Shareholders equity                 | (2,794)        | (2,941)        | (3,055)        | (3,189)        | (3,290)        |
| Total liabilities                   | 10,678         | 11,647         | 12,265         | 12,656         | 12,789         |
| <b>Cash flow</b>                    |                |                |                |                |                |
| EBIT                                | 969            | 1,038          | 1,009          | 1,074          | 1,057          |
| Depreciation                        | 421            | 443            | 472            | 499            | 518            |
| Change in working capital/others    |                | (122)          | (49)           | (55)           | (47)           |
| Non-cash items/tax benefits         |                | (21)           | (37)           | (30)           | (29)           |
| Cash flow from operations           |                | 1,337          | 1,395          | 1,487          | 1,500          |
| Interest                            | (93)           | (100)          | (144)          | (176)          | (216)          |
| Tax                                 | (412)          | (424)          | (350)          | (364)          | (341)          |
| Capex and investments               | (1,235)        | (1,212)        | (1,097)        | (851)          | (656)          |
| Free cash flow                      | (393)          | (399)          | (196)          | 96             | 287            |
| Dividends                           | (422)          | (402)          | (402)          | (402)          | (402)          |
| Others                              | 81             | 32             | 0              | 0              | 0              |
| Net cash flow                       | (733)          | (769)          | (597)          | (305)          | (114)          |
| <b>Per share data</b>               |                |                |                |                |                |
| EPS                                 | 0.23           | 0.26           | 0.26           | 0.27           | 0.25           |
| DPS                                 | 0.20           | 0.20           | 0.20           | 0.20           | 0.20           |
| CEPS                                | 0.44           | 0.48           | 0.49           | 0.51           | 0.51           |
| FCF                                 | (0.17)         | (0.13)         | (0.05)         | 0.09           | 0.18           |
| NAV                                 | 1.39           | 1.46           | 1.52           | 1.59           | 1.64           |
| <b>Ratios</b>                       |                |                |                |                |                |
| EBIT margin (%)                     | 53.7           | 54.9           | 53.3           | 54.0           | 53.0           |
| Effective tax rate (%)              | 47.0           | 45.2           | 40.5           | 40.5           | 40.5           |
| Pay out (%)                         | 86%            | 78%            | 78%            | 75%            | 80%            |
| ROE (%)                             | 16.6           | 17.5           | 16.8           | 16.7           | 15.2           |
| ROCE (%)                            | 11.2           | 10.8           | 9.8            | 10.0           | 9.7            |
| Interest cover                      | 10.5           | 10.4           | 7.0            | 6.1            | 4.9            |
| Gearing (%)                         | (209.6)        | (225.3)        | (236.4)        | (236.0)        | (232.2)        |
| Ave. number of shares in issue (mn) | 2,009          | 2,009          | 2,009          | 2,009          | 2,009          |

Source: Company Reports and Citi Research Estimates

## TERNA SpA

### Company description

TERNA is the electricity transmission company of Italy, holding a market share of c96%. Its transmission operations are entirely regulated. TERNA also provides transmission services to ENEL, its parent company, as well as to other clients outside the ENEL group. The group has also entered the solar business.

### Investment strategy

We rate Terna Sell. Terna is a solid defensive stock that benefits from a clear and stable regulatory environment that allows for incentives on investments for new infrastructure. Due to the regulatory framework, Terna distinguishes itself with its earnings and cash flow predictability and a solid balance sheet. Nevertheless, the stock trades at a substantial premium to RAB, which we believe is unjustified considering its low growth prospects (EPS -0.8% 2013-18E) and the mature regulatory environment.

### Valuation

We value Terna using an RAB-based approach for its Italian transmission activities, which are its core business. To this end, we adopt an RAB-based DCF where for the terminal value we use the RAB as at the end of 2019 (coinciding with the end of the fourth regulatory period). Our SOTP valuation is €3.15, which we set as our target price.

### Risks

The following risks could prevent achievement of our target price. While the domestic business looks reasonably safe we cannot exclude Terna may want to enter new foreign markets with little regulation or where regulators have no proven track record in terms of stability and consistency. Terna faces the risk that some of its projects could be delayed. Terna current regulatory period ends in December 2015, creating some uncertainties over future allowed returns. On the upside, the company might announce international and business diversification that could create value in the future.

## Appendix A-1

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#### Ratings and Target Price History Fundamental Research

Analyst: Antonella Bianchessi  
Covered since June 23 2011



|   | Date      | Rating                      | Target Price | Closing Price |
|---|-----------|-----------------------------|--------------|---------------|
| 1 | 31-Aug-11 | *1L                         | *3.10        | 2.52          |
| 2 | 7-Oct-11  | Stock rating system changed |              |               |
| 3 | 8-Oct-11  | *1                          | 3.10         | 2.84          |
| 4 | 12-Dec-11 | 1                           | *2.90        | 2.51          |

\* Indicates change

|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 5 | 6-Mar-12  | *2     | *3.00        | 2.83          |
| 6 | 21-Mar-12 | 2      | *3.10        | 3.00          |
| 7 | 25-Jul-12 | 2      | *2.80        | 2.55          |
| 8 | 10-Oct-12 | *3     | 2.80         | 2.88          |

|    | Date      | Rating | Target Price | Closing Price |
|----|-----------|--------|--------------|---------------|
| 9  | 4-Feb-13  | 3      | *2.90        | 3.03          |
| 10 | 23-Apr-13 | 3      | *3.00        | 3.43          |

Rating/target price changes above reflect Eastern Standard Time

### TERNA SpA (TRN.MI)

#### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Antonella Bianchessi  
Covered since June 23 2011



|   | Date     | Rating  | Target Price | Closing Price |
|---|----------|---------|--------------|---------------|
| 1 | 2-Nov-12 | *ADD LP | -            | 2.90          |
| 2 | 6-Feb-13 | *REM LP | -            | 3.10          |

\* Indicates change

|   | Date      | Rating  | Target Price | Closing Price |
|---|-----------|---------|--------------|---------------|
| 3 | 25-Sep-13 | *ADD LP | -            | 3.38          |
| 4 | 11-Feb-14 | *REM LP | -            | 3.68          |

Rating/target price changes above reflect Eastern Standard Time

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|-----------------|------|------|-----------------|------|------|
| Buy             | Hold | Sell | Buy             | Hold | Sell |
| 49%             | 40%  | 12%  | 6%              | 88%  | 6%   |
| 55%             | 52%  | 44%  | 62%             | 52%  | 49%  |

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