EDITED TRANSCRIPT

Snam – 2017 1Q Earnings Call

MAY 4, 2017

Investor Relations Snam
T +39 02 37037272 F +39 02 37037803
investor.relations@snam.it

Corporate Participants

- Alessandra Pasini
  Snam SpA - CFO

Conference Call Participants

- Anna Maria Scaglia
  Morgan Stanley, Research Division - Research Analyst
- Enrico Bartoli
  MainFirst Bank AG, Research Division - Senior Analyst
- Harry Peter Wyburd
  BofA Merrill Lynch, Research Division - VP and Junior Analyst
- Javier Suarez Hernandez
  Mediobanca - Banca di credito finanziario S.p.A., Research Division – Research Analyst
- Olivier Van Doosselaere
  Exane BNP Paribas, Research Division - Research Analyst
- Stefano Gamberini
  Equita SIM Spa, Research Division - Analyst

Presentation

OPERATOR

Good day, and welcome to the Snam 2017 first quarter results conference call. Today's conference is being recorded.

At this time, I'd like to turn the conference over to Ms. Alessandra Pasini. Please go ahead, ma'am.

ALESSANDRA PASINI – SNAM SPA – CFO

Good afternoon, ladies and gentlemen, and welcome to Snam's 2017 first quarter results presentation.

In the quarter, gas demand was up by 2 bcm, mainly thanks to the thermoelectric and industrial sectors. Our good financial results benefited from the positive contribution from our regulated business, our continued focus on efficiency, capital structure optimization and a lower corporate tax rate. These results were further enhanced by temporary or seasonal effects, which I will explain later in the presentation.

In the quarter, we also executed EUR 201 million of share buyback. Funding costs were further reduced, thanks to the liability management exercise of last year and also to the new issuance of EUR 1.2 billion done in the first quarter of this year. The first quarter results provide a solid start and allow us to confirm the full year guidance.

Let's now look at gas demand. In the first quarter, demand was up for the ninth consecutive quarter by almost 9% on a nonweather-adjusted basis. Half of the overall improvement or 1 bcm was driven by power generation where gas demand was supported by reduced input from France, owing to the new (inaudible) Down that highlighted once again the importance of gas capacity for the security of the system.

In addition power generation from hydroelectric and wind was lower during the quarter. This trend has continued in April. The increase in gas consumption of the industrial sector is mainly driven by the steel, mechanical, chemical and paper segments, pointing to a continuing underlying recovery of the Italian industrial production.

Residential demand was flat on a weather-adjusted basis. Gas injected into the system was up 15%, reflecting higher demand and lower gas withdrawals from storage relative to last year.

Turning now to our results. EBIT in Q1 was EUR 353 million, up EUR 22 million or 6.6% over the same period of the prior year. The EBIT number reflects approximately EUR 8 million increase of regulated revenues due to the yearly tariff update; controllable fixed cost reduction of EUR 4 million, out of which circa EUR 2 million are from the first result of [our] savings initiative that are on track to reach the target of more than EUR 10 [million] savings for the full year set during our recent strategy presentation; higher amortization in line with our asset profile evolution of about EUR 10 million. In addition, it is worth flagging that this number contains higher storage revenues for EUR 5 million for a different time profile of tariffs compared to the prior year, which will be absorbed in the second quarter. The increase in transport revenues as a result of the higher transported gas, about EUR 5 million. As a reminder a small part of our revenues, up to plus or minus EUR 9 million for the full year, is connected to gas volume that, as I previously said, have been very high in the first quarter 2017. Lower risk provision recorded in the first quarter of the year, about EUR 3 million; capital gain on sale of materials and reduction in cost caused by different phasing of spending, which we expect to normalize in the next quarter.

Turning to net profit. The first quarter 2017 recorded an increase of EUR 42 million from 2012 to EUR 254 million. The increase was mainly driven by the previously commented increase in EBIT; lower net interest expenses of EUR 19 million, thanks to the reduction of the cost of debt, driven by the liability management executed last year, new issuance executed in this first quarter and lower leverage debt after the demerger of Italgas from EUR 11.7 billion to EUR 10.8 billion; higher contribution from associates, which also reflects the positive contribution of GCA that was acquired at the end of 2016. Please remember that this was the last quarter in which TIGF transport business benefited from a WACC of 6.5%, which has been lowered from the beginning of the second quarter 2017 to 5.25% due to the last well-known regulatory review. In the end, higher taxes due to higher earnings before tax, notwithstanding the reduction in the corporate income tax rate. The tax rate for the quarter was around 25% in line with expectation.

Cash flow from operations amounted to EUR 917 million. This number includes EUR 53 million award in a positive working capital and EUR 90 million owing to net tax payments; EUR 143 million from the balancing activities, offsetting the absorption that we saw in the last quarter of 2016, also in the context of a better supply market; EUR 259 million mainly due to the time line between the cashing of tariff-related items, which are attributable to past periods and not yet paid to the equalization fund.

The reported cash flow from operations fully financed net investment of EUR 355 million, including the further investment related to our participation in TAP of circa EUR 50 million. Following the share buyback activity of EUR 201 million, the reduction in net debt was EUR 362 million.

Our guidance for the full year of EUR 11.5 billion of net debt is confirmed. We remind you that this assumes EUR 0.3 billion of true-ups from tax financing and essentially neutral working capital, which is our expectation for the year as a whole.

Cash flow from investments is EUR 355 million due to the EUR 183 million of net CapEx and EUR 119 million of change in payables mainly related to investment made in 2016. The CapEx plan in our core Italian portfolio is progressing well, thanks to our operational excellence in project management. These allow us to confirm the guidance of EUR 1 billion CapEx for the full year.

In addition, obviously, we will have the full contribution of the equity call for tax, so our total investment for the year is confirmed at EUR 1.3 billion.

Now let me give you an update on Snam's debt structure. As regards the capital markets, in the first quarter, Snam raised an aggregate amount of EUR 1.2 billion at an average cash yield of 0.7%, well below our current average cost of debt, with an average maturity of 6.3 years, further extending the average life of medium- to long-term debt. This includes the 5-year EUR 400 million equity convertible bond recently issued by Snam, which is the second 0 coupon issuance in the last 6 months.

As regards to debt breakdown, the fixed rate portion is 85%, well above the 64% of year-end 2016 as a result of the fixed rate bond issuances in the first quarter and the unwinding of a fixed-floating interest rate swap of EUR 500 million. We confirm our guidance of 3/4 fixed-floating debt for 2017.

The maturity profile is well spread over time and our liquidity profile remain strong with EUR 3.2 billion of undrawn committed credit line. Our cost of debt averaged 2.2% in the first quarter 2017, already in line with our guidance, with some room to further upside, thanks to the benefit of the action executed in the first 3 months of 2017 and possible treasury management optimization.

And now let me give you some more color on the share buyback program and the recently issued convertible. In March, Snam issued a 5-year EUR 400 million convertible at 0 coupon and 0 yield driven by the following rationale: the convertible bond is a chief source of financing with cash saving of circa 80 basis points versus an equivalent plain vanilla bond, although no P&L affect is visible for reasons related to the accounting treatment of the equity component of the instrument. Being entirely served by own treasury shares, the convertible bond is cash-accretive for circa EUR 20 million per year, due to cash saving on financial charges on top of dividend savings on the underlying treasury share.

The effective conversion premium is over 50% based on dividend yield issuance. In addition, Snam was able to create value because the share buyback average purchase price was lower than the equity convertible reference share price. Moreover, the equity convertible has enabled Snam to tap a different source of funding. The success of the transaction confirm the strong support of investors on Snam's equity story.

Thank you for your attention, and I will now be delighted to take any questions you may have.

QUESTIONS AND ANSWERS

OPERATOR

We will now take our first question from Harry Wyburd of Merrill Lynch.

Harry Peter Wyburd - BofA Merrill Lynch, Research Division - VP and Junior Analyst

A couple of questions for me. Firstly, on the convertible bond, could you just clarify something you mentioned on the slide there that because of the equity or the accounting treatment of the equity component that there's no P&L impact. If I understand correctly, what you're saying is that you get a cash saving on interest, but there's actually no cash -- there's no interest cost saving in the P&L. Could you just clarify that? And then secondly, and more generally, just your earnings guidance I believe in the long-term based on the [CAGR] that you gave at the full year results assumes a 20 bps cut in the allowable return in 2019. So I just wondered if you could update us on what your outlook for that allowable return is given that the spread between Italian BTPs and German [bonds] remains very wide, which should suggest a potential or a possible upgrade in the allowable return. What is the sensitivity of your net income if you -- instead of assuming a 20 bps cut actually had that being flat?

Alessandra Pasini - Snam SpA - CFO

Thanks for your question. As it regards to the convertible, what I meant is that, effectively, this is a cash 0 coupon, but the P&L will show the cost of the instrument with a figurative 80 bps as it is -- if it was a traditional plain vanilla bond. That's the way account -- from an accounting standpoint, you will see the numbers, but the cost on a cash basis is 0. As it relates to the allowable return, nothing has changed versus what we said to the market at our strategy presentation, we have no element to take a different stance than what we said before. Spread were exactly where they are today. So we don't really have any additional implication to take from where we are today. And also as we are getting closer to regulatory reviews, we don't want to guide the market towards adjustment that may be positive due to the simple [counter risk] premium spread.

Harry Peter Wyburd - BofA Merrill Lynch, Research Division - VP and Junior Analyst

Okay. And just coming back on the first question there, on the convertible (inaudible), so there will be a P&L charge. What does that work out at as an effective interest cost on the bond?

ALESSANDRA PASINI – SNAM SPA – CFO

As I said, it's 80 bps on EUR 400 million, that's the nominal figurative number that you would see pro rata for the convert. Cost on a cash basis is going to be 0.

Operator

Our next question comes from Enrico Bartoli of MainFirst.

Enrico Bartoli - MainFirst Bank AG, Research Division - Senior Analyst

A couple of questions on my side as well. First of all, on operating costs, if I'm right, actually they were down compared to the first quarter last year by EUR 19 million. Could you please elaborate a bit on the drivers of this cost reduction? And on which part of this reduction can be sustainable and repeatable over the next quarters? A second question is related to the associate figure. If you could please give us the contribution from TIGF, [Targa] and Gas Connect to the figure? And finally, on the memorandum of understanding that you signed in the Ukraine recently, could you provide us some details on the possible business development there? I don't know, if possible, some indication of the level of revenues that you think that can be achieved in that market and if something similar can be replicated in other countries.

ALESSANDRA PASINI – SNAM SPA – CFO

Okay. So as it relates to cost, I think what is important is that out of the EUR 4 million of reduction in controllable fixed cost that we had in the first quarter, about EUR 3 million can be considered structural, of which 2, thanks to our cost-cutting initiatives that are part of the broader plan that we did present in March. The remainder of EUR 1 million for the fixed controllable costs is connected to a different timing of spending. So we expect that to be reabsorbed during the rest of the year. Overall, we remain confident that we will hit a flat fixed controllable cost guidance for 2017 in -- as we said it in the past. The second question was I think -- or the third was in relation to the MOU that we signed recently in relation to Ukraine. That -- for us, that is first step for a possible contract that involves non-global solution. So it's more related to possible engineering and project management services, not to deployment of capital. We gave some indication of what we're trying to do with non-global solution and that goes into that direction. Sorry, what was the third question?

Enrico Bartoli - MainFirst Bank AG, Research Division - Senior Analyst

[That was related] -- if this kind of opportunity in terms of business can be also replicated in other countries? And the last one was the breakdown of the EUR 41 million of associates.

ALESSANDRA PASINI – SNAM SPA – CFO

Yes. As it relates to last one, unfortunately, some of our associates haven't reported yet. And so we stick to the aggregated number of EUR 41 million for the quarter. As it relates to future opportunities for non-global solution (inaudible) situation, yes. Obviously, we will keep looking for additional opportunities of this nature of asset-light services that we are try to progress on.

Operator

Our next question comes from Javier Suarez of Mediobanca.

Javier Suarez Hernandez - Mediobanca - Banca di credito finanziario S.p.A., Research Division - Research Analyst

Two or three questions on my side, too. The first one is coming back on the Slide #13 on the total cost of the company that are down quite sizable -- sizably. You have mentioned that EUR 3 million are [structural]. I just wanted to have, if you can help us to understand, what is behind the EUR 4 million reduction in variable cost and then EUR 5 million of reduction in other cost, if you can help us understand the reason for that and why that should be reverted through the year. Second question is on the working capital improvement. There has been some sizable improvement during the first quarter. And it could be conservative to consider that working capital effect by the year-end could be 0 as you mentioned during your speech. And if so, which are the reasons [how they feel] that could make working capital to contribute positively by the year-end? And the third question is, during your presentation, you mentioned that the EUR 2.2 million -- 2.2% cost of debt has some room for improvement. Can you help us to understand which is the room that you believe the company has to reduce the cost of debt through 2017?

ALESSANDRA PASINI – SNAM SPA – CFO

Okay. So in terms of other costs, the variable reduction is mainly related to noncash item that are related to evolution of gas inventory and the [full] we expect it to overall normalize during the course of the year. As I said, where other cost reduction in terms of lower risk provision, lower depreciation, if you wish. I think there are elements which are structural, all the rest of it we expect to normalize as different savings during the rest of the year. So I think that the combination of at least EUR 10 million of cost reduction to our saving initiatives on one side and flat fixed controllable cost, I think, which is confirmed from our prior guidance, is something that we are able to confirm today. When it comes to working capital improvement, it's basically related to a different time line between when we receive money and when we give this to the stock equalization fund. So that was the effect that we got for the first quarter. We do expect this to normalize. It's a different way of looking at the 2 months that we need to pay as part of the additional tariff components to the equalization fund. So we do see this as a temporary effect, which will be, by the year-end, effectively neutralized. When it comes to cost of debt, effectively the upside should come from a number of things. First, the full benefit of the actions that have been executed during the first quarter. So the omission and the benefit of the unwinding of the derivative that we commented on. We also expect to have some benefit from an additional utilization of banking facilities that will, on one side, balance the mix fixed-floating, but at the same time given the terms that we have for our banking lines will help us potentially to optimize our funding cost, as well as continuing benefit for last year's actions in terms of liability and management. The last point that is worth reminding is that, as you know, we do have a bond that is expiring in June. The coupon of that bond is about our right average. So obviously, that will mathematically further give some small improvement.

Operator

Our next question, ladies and gentlemen, comes from Stefano Gamberini of Equita SIM.

STEFANO GAMBERINI- EQUITA SIM SPA, RESEARCH DIVISION - ANALYST

A few questions if I may. First of all, regarding the TAP situation, could you update us regarding the last events on the TAP and if there are some significant delays on CapEx due to the program seen in South Italy. The second, there were some rumors on the press that the Italian government was interested in the Poseidon IGI project that could even enter in the initial energy strategy, could be something that is interesting for you. And these rumors reported of a EUR 6 billion project, if this is something that in your view is real. Last thing, regarding this guidance on OpEx fixed controllable cost for the full year. With the EUR 10 million reduction of cost, how this could be fixed in real terms? So what is the inflation that you expect [to do in] '17?

ALESSANDRA PASINI – SNAM SPA – CFO

Thanks, Stefano. As it relates to TAP, TAP is a strategic project that benefit Italy and Europe and is invisible once it's completed with very limited impact from an environmental perspective. The first tranche of work, which involves preparing the ground for the activities on the [micro-tunnel] has been completed. All the olive trees that have been moved will be planted in the same position after the underground has been led. In our plant, TAM is assumed to come into operation in 2020, and there is no expectation of delay as of now. And the expected contribution, just as a reminder to everybody, to our net income in 2021 is around EUR 15 million -- sorry, EUR 50 million. So nothing has changed. What should have been done has been done, and we are on track. When it comes to Poseidon, we don't have elements to comment on the value of project in which we are not involved, that's the first reaction. Consider that we evaluate any initiative that may arise if, particularly, if it involves Italian gas network with the investment criteria that we did present our strategy presentation, i.e. we target risk-adjusted returns that are at least in line with our regulated Italian activities. We are -- maintaining our rate -- credit rating is a firm gate for us. And we also focus on opportunities that allow us to play an industrial role and that support long-term growth. On OpEx, I think, overall, the inflation, if we also consider labor cost, is probably around 1.5%, roughly speaking. So that maybe help you to combine the guidance we gave on total cost of at least EUR 10 million savings with the expectation of flat in real terms fixed controllable cost.

Operator

Our next question, ladies and gentlemen, comes from Olivier Van Doosselaere of Exane.

OLIVIER VAN DOOSSELAERE- EXANE BNP PARIBAS, RESEARCH DIVISION - RESEARCH ANALYST

I had 4. The first one was relating to the fact that the Greek government seems to have come to an agreement now with its creditors that would include again some privatizations and I think the potential sale of the gas transport network is part of that. And also the idea seems to be, I think, it should be sold to a European actor which actually has transport capabilities. So I guess, you would actually quite naturally come into the picture then in terms of potential candidate. Is that something that you could actually be interested in? I know that you -- we know that you have (inaudible) in the past. A second one is on other new investment opportunities but domestically, you have said that the full year results that maybe in the future there could be some news that could come up in terms of new LNG or further investment in the Adriatic backbone in Sardinia. I was wondering, I know that the full year results were very recent. So I don't know if there's been any further or new discussion that would have started on that. Third question is on the -- well, on the convertible bonds and on the share buyback. I think that initially, the idea of a share buyback was that it was going to be used as a tool to optimize your capital structure now if that will actually be used as a backup to a convertible, if we would take actually the assumption that it would be converted in the end, would you see scope for Snam now to decide to raise its share buyback program again? And then the last question is on the tax rate. I think you mentioned the 25% tax rate in Q1, that seemed actually a bit low to me relative to what I would have expected for the full year. So if you could confirm what your full year expectations are for tax rate for 2017 and maybe for the years ahead?

ALESSANDRA PASINI – SNAM SPA – CFO

Thanks, Olivier. As it comes to Greece, first, we don't usually comment on any M&A rumor or speculation. And in addition, the new privatization process has not yet been the final or decided. There's a lot of rumors and expectations. But when the picture will be clear, we will take a look at what is the situation and decide what will be our possible interest in the tender. In any case, we will examine this transaction as every other transaction, applying a strict financial discipline and only pursuing an industrial role rather than a financial role. As it comes to Italian additional growth opportunities, as we flagged in our strategy presentation, nothing has changed in that regard. Those that we are licensed remain those that we may consider or that we would be interested to consider should they be possible and [feasible]. But we don't have much to report. When it comes to the share buyback, you will remember that our latest shareholder meeting, we extended the maturity of our buyback up to October 2018 without changing the overall size. We also indicatively gave the signal at the strategy presentation that we were currently planning to only complete up to 2/3 of it and not all of it. Nothing has changed in our mind. As we said, yes, the buyback is a good financial flexibility tool to optimize our capital structure, but we've also been very steady in running the buyback algorithm when our share and implied premium drop was overall value-accretive in our view. And that principle remains valid. When it comes to tax rate, the first quarter is typically a lower tax rate quarter. So the 25% that we had in the first quarter of this year should be compared to the 27% last year. Of course, we had the benefit of the lower (inaudible), but we had some impact of lower benefit from (inaudible). Overall in terms of full year guidance, we expect tax rate to be in the 27 to -- sorry, 26% to 27% area.

Operator

Our next question comes from Anna Maria Scaglia of Morgan Stanley.

Anna Maria Scaglia- Morgan Stanley, Research Division - Research Analyst

Just a very quick question from me. I was wondering if you have had any update on the timing of the review? And whether now is it clear to you whether the new regulatory year will be in 2019?

Alessandra Pasini - Snam SpA - CFO

Very quick answer, no. We have no update, sorry.

Operator

As there are no further questions, I'd like to turn the call back over to the speakers for any closing or additional remarks.

Alessandra Pasini - Snam SpA - CFO

Thank you, everybody, for your time and availability.

Good afternoon.

Operator

That will conclude today's conference call. Thank you for your participation, ladies and gentlemen. You may now disconnect.