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2019 Interim Results Snam SpA Earnings Call

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Corporate Participants

- Alessandra Pasini
Snam S.p.A. - CFO
- Marco Alverà
Snam S.p.A. – CFO & Director

Conference Call Participants

- Anna Maria Scaglia
Morgan Stanley, Research Division - Research Analyst
- Emanuele Oggioni
Banca Akros S.p.A., Research Division – Analyst
- Enrico Bartoli
MainFirst Bank AG, Research Division – MD
- 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
- Stefano Gamberini
Equita SIM S.p.A., Research Division - Analyst



Presentation

OPERATOR

Good afternoon, ladies and gentlemen, and thank you for standing by. Welcome to today's Snam's 2019 Half Year Results Conference Call.

(Operator Instructions) I must advise you that this conference is being recorded today, Thursday, the 1st of August, 2019. I would now like to hand the conference over to your speaker today, CEO, Marco Alverà. Please go ahead, sir.

MARCO ALVERÀ SNAM S.P.A. - CEO & DIRECTOR

Thank you. Ladies and gentlemen, good afternoon, and welcome to Snam's 2019 Interim Results Presentation. Looking first at the scenario, the outlook for gas infrastructure continues to improve. Gas prices are down in the last 12 months, touching a low of EUR 10.5 per megawatt hour in June, which is 50% down year-on-year. This was also driven by the oversupply European LNG markets.

This decline, together with a quick increase of CO2 costs of also about 50% in the first half has made coal-to-gas switching, increasingly convenient in many European countries. Lower gas prices heading into the summer season have also opened summer winter spreads, increasing the use of storage throughout Europe. Taking a closer look at Italy, gas for power in the first half was up 17%, driven by lower power import from France, lower hydro availability in Italy and the decline in the use of coal.

Looking more specifically at June, when Italy and Europe were going through a heatwave, gas demand for power rose as much as 24% compared to the previous year. As electricity demand rose for cooling, hydro production was lower because this heatwave was also dry, and coal declines continued with consumption down 34%. This volatility in gas demand for power generation, which was up 24% in the context of a 2.8% rise in power demand, highlights the value of the gas systems flexibility in dealing with intense weather conditions that are becoming more common, both in the winter as well as in the summer. In this context, our business plan is progressing well. We now have visibility up to 2023 on the key pillars of our regulatory system. The final document on the fifth regulatory period confirmed the existing framework, as does the more recent consultation document for storage. We're continuing our constructive data with the regulator, both on output-based incentives and asset health. Our CapEx plan is in line with our full year budget, and we're improving our



capacity to deliver new regulated services for the Italian market. We have earned EUR 9 million compared to the same period in 2018.

Meanwhile, we're continuing to cut costs by another EUR 5 million in the first half of the year. We're continuing to strengthen our exposure to the energy transition. Overall, we completed over 100 new interconnections to our grid from biomethane plants and natural gas service stations. Snam 4 Mobility has now contractualized 73 new CNG or LCNG stations and recently signed an agreement for a further 26. TAP is progressing well and is now 88% complete. DESFA's regulatory review in risk is positive, and the steep decline in Greek spreads has improved the risk-adjusted outlook for this asset.

We continue to create value through the optimization of the financial structure of Snam and treasury management, also leveraging on our ESG approach to access new sources of funding. We recently secured a loan from EIB to fund our sustainable mobility business, and we issued the first European climate action plan. This progress translates into solid first half results. Regulated revenues were up 3.3%, driven by the growth in the asset base, the increase in the WACC and the increase in the output-based incentives. EBITDA was up 4.4% as a result of higher revenues and of the additional efficiency achieved in the first half. Income from associates was up 39% due to the DESFA acquisition that was completed at the end of last year and the higher result of Teréga, also due to a one-off effect from the release of the tax provision in the first quarter. Net income was up 11%, also benefiting from lower financial charges due to the bond rollover and further efforts on treasury management, leveraging on favorable market conditions. We don't expect all of the positive effects in the first half of the year to continue for the second half. The strong results so far allows us to revise our guidance upwards from a growth in net income of 5% year-on-year to a growth of between 6% and 7% on a full year basis.

I would also like to take this opportunity to highlight the progress we're making on ESG. ESG has been further incorporated into our government, and we've appointed a dedicated specific new ESG board committee, which has oversight on all our environmental, social and governance teams. Starting with sustainability of our operations, we're continuing to reduce methane emissions and are well on track to reaching our long-term objective.

Meanwhile, we're continuing to study the full potential of green and low-carbon [gas and] density and working together with the regulator on the long-term scenarios. Deeper and faster decarbonization target, which are currently being discussed across Europe, implies significant potential volumes of hydrogen, which is quickly emerging as a solution for the hard to abate sectors. Hydrogen benefits from falling costs of renewable generation and a much lower cost of transport and storage compared to other renewable alternatives. And of course, hydrogen also benefits from the possibility of leveraging existing gas infrastructure.



Earlier this year, we ran a pilot project to supply a blend of hydrogen and natural gas into the transmission network, and we went all the way to end industrial users. This was the first in Europe, and it's a first step to ensure the readiness of our asset base for this new created gas.

Realizing the potential of green gas will require significant investments in terms of energy infrastructure. In order to contribute to this very important debate, we will be holding a global hydrogen ESG conference, together with the IEA, IRENA and the Italian government in Rome on October 10, in which you are all invited.

Thank you for your attention. I will now hand over to Alessandra for a closer look at results.

ALESSANDRA PASINI SNAM S.P.A. - CFO

Thank you, Marco. [We signed] the first half was EUR 1,111,000,000 million, as EUR 47 million over the same period of prior year. This number reflects increase in regulated revenues of EUR 40 million, mainly due to the increase in [allowed renovation], that is probably increased and a gradual ramp-up in regulated services for EUR 3 million, EUR 2 million in the balancing activities, which we already had last year and EUR 1 million in storage services, which is a new service launched this year.

This is the effects on the cost-cutting plan that delivered further EUR 5 million in the first half of this year and is expected to generate more than EUR 45 million saving by year-end, since the beginning of the plan, which, as you recall started on the basis of (inaudible). Other components largely offset each other. They include negatives, such as higher costs on the initiatives and their integration, higher provisions and positives, such as higher sales and materials and lower earnings costs, mainly reflecting the recovery of cost of sales in [2019].

Looking at our process in more detail, the increase in net income contribution was driven by Teréga, was EUR 14 million, thanks to the increase in the asset base and lower depreciation related to distribution premium, but also through a one-off effect collected to the release of a tax provision accrued in 2017.

Positive options on 2019 capacity interconnection and the entry of DESFA in the perimeter. Its performance-related volumes and is [good for] business, with the first quarter expected to be the lowest in the year. You may have seen before this the [outlook on rate regulation], which is roughly looks for the development investments and revised remuneration, which partially incorporates the significant improvement in weak macro environment.



We expressed at the beginning of the prior regulatory period we're 700 basis points and are now [250] basis points, while the new allowed remuneration has moved for 2019 from 9.22% to 8.23%. These companies, which we account for using the equity medicines provide EUR 95 million of net income contribution in the first half. For the full year, we are not expecting this number to double as deposits [in Senegal], and that effect will not apply consistency looking forward. The consultation is ongoing in front on the next regulatory period for transport and storage. The (inaudible) is lower than the current one, also because the discounting and deal reduction in the corporate tax rate.

Overall, the impact on our social portfolio will be decreased. As a reference, our pro forma share of international ports EBITDA, it will be EUR 207 million in the first half of the year.

Moving to the net profit for the first half, it was up EUR 58 million compared to last year. This was driven by the positive performance of our operations, net of EUR 20 million of higher [D & A] , lower net interest expenses of EUR 13 million, thanks to last year as we saw management, bond rollover and treasury optimization carried out in the first half and higher taxes due to a higher earnings before tax. The tax rate for the period was around 26.3% of GDP, including associates versus 27% last year. Cash from operation benefited from positive working capital of EUR 341 million. That includes EUR 310 million of tariff-related items, of which EUR 295 million of additional tariff components and EUR 15 million due to overcharging. Both were mainly very strong during the year. We've also considered that about EUR 180 million related to the charges and penalties cashed in, in the last year has just been paid in July. The operating cash flow for net investment and equity cash flow, mainly including the payment of the interim and financial and final dividend of EUR 746 million, leading to the net debt in the first half of EUR 11.5 billion. This confirm our year-end net debt guidance of EUR 11.7 billion. That includes a negative working capital of [EUR 100 million].

But now -- to give you an update on our debt structure. In the first half, we issued [EUR 750 million] with an average cost of 1.5% and a tenure of 8 years, EUR 500 million were climate action bond and EUR 250 million were final product placements. This was late here to [EUR 770 million] bonds at an average cost of near [30.8%] expired in the first half. Furthermore, 3 new [VAT] loans have been signed in the first part of the year for a total amount of [EUR 370 million], of which one has been signed yesterday for an amount of EUR 105 million, with an average maturity of over 20 years and an average cost of circa 1% at a fixed rate.

On the banking side, realize that we have achieved the target envisaged in our EUR 3.2 billion sustainable loan, improved [gas in EBITDA] of [2.5] basis points on the [safety]



margin, starting from April 2019, and we are expanding the EUR 3.2 billion indicated loan by 1 extra year. In the second part of the year, we will be focused on the following actions: potential opportunistic prefunding; continued focus on treasury management utilization; and optimization of our financial structure, including our (inaudible).

Thank you for your attention. We will now be pleased to answer your question.

MARCO ALVERÀ SNAM S.P.A. - CEO & DIRECTOR

Yes. We're happy for Q & A now.

QUESTIONS AND ANSWERS

OPERATOR

(Operator Instructions) Our first question comes from the line of Harry Wyburd from Bank of America.

HARRY PETER WYBURD BOFA MERRILL LYNCH, RESEARCH DIVISION - VP AND JUNIOR ANALYST

I've got 3. And so firstly, just on the new updated guidance. You've increased your net profit growth guidance of 6% to 7% this year. I presume with the buyback, the EPS growth will be slightly higher than that. And then looking forward to next year, should we just apply the 5% EPS growth guidance on the new 2019 base? Or is there a one-off element, so that's going on this year, which means the 2020 growth could be slightly lower? And then the second question is on DESFA, but that seems to be going very well. Could you just remind us how much of this improvement is structural? If you could remind us what volume gearing sits in that business? And how we should think about volumes? And then just update us, you touched on it earlier about data? So a bit more on the regulatory outlook there. And then finally, just a clarification on Slide 8 with Teréga, you mentioned lower residual depreciation of the acquisition price premium. Could you just explain what that is? Is that just a lower PPA amortization of purchase price allocation amortization? If you could just explain what that is and whether it's recurring?



MARCO ALVERÀ SNAM S.P.A. - CEO & DIRECTOR

Okay. Thank you, Harry. On guidance, we do not assume or give any buyback guidance year-on-year. And I would say that for next year, we will talk about that in the context of the presentation that we will do for the new plan. On DESFA and Teréga, I would hand over to Alessandra.

Alessandra Pasini Snam S.p.A. - CFO

On Teréga, it's approximately EUR 7 million lower PPA. That's the effect that we were referring to. On DESFA, the new regulation, as I said, is positive. First, there is an element of better-than-expected and even when -- given that what we said, 1 year ago in terms of the evolution of the remuneration vis-a vis-à-vis market environment, which will improve much more than what is effective, included in the WACC. On the volumes, it's not the volume exposed regulation. I just want to be clear, what was, in our case, the volume adjust during the year, effectively. In the case of DESFA, this is a cross-year phenomenon that [yet we have sold]. This gives a little bit of volatility. At the same time, with the [road] based regulation, where volumes are potentially extemporary upside rather than structural upside. In addition, when the market is performing very well in terms of volumes, we are accelerating the recovery of some old tariff-related items. The -- some of these elements is what is giving the performance of DESFA for the first part of this year particularly strong contribution.

Operator

Our next question comes from the line of Javier Suarez.

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

Three on my side. The first one is coming back to the increase in the guidance for 2019. I just wanted to be sure of the reasons behind this increase in the upgrade for the net income guidance. Is that mainly related to the better performance on the equity consolidated lines? And if so, is that something structural or is something related to some one-off? I'm just -- the thing that I'm trying to understand, is the increase in the guidance is related to these release in the tax provision and lower residual depreciation, that you are mentioning on Slide #8? Or if there is something structural there that is making your performance in, I guess, DESFA and Teréga better than expected. Some clarification there



will be helpful. Then on the cost cutting, in Slide #7, you are mentioning EUR 5 million of positive contribution from the ongoing efficiency program. You continue to have your latest view on where these numbers should be by the year-end, i.e., which should be the contribution of the cost-cutting and to the EBITDA by the year-end? The latest thing is on the -- there has been a regulatory paper issued by the French Authorities on the [test] transmission and the storage business, affecting Teréga. Any comment on that regulatory document on how -- do you believe that the document could be improved or -- and that would be helpful as well.

Marco Alverà Snam S.p.A. - CEO & Director

Okay. Thanks, Javier. So on the guidance, moving from [5%] through a range of 6% to 7% is about EUR 20 million. And I would say that's almost evenly split between the lower financial charges that Alessandra talked about in detail related to treasury management and to generally better-than-expected cost of funding. And the other half is related to the income from associates, about evenly split between Teréga and DESFA. And as we said, some of these do have an element that's nonrecurring. Regarding the cost cutting, the full year would benefit from around this 5 extra million. So we're now targeting around or greater than EUR 45 million overall. For Teréga, you want to take this one?

Alessandra Pasini Snam S.p.A. – CFO

Yes, on the -- clearly, we are supporting Teréga in its effort on the consultation with the French Regulatory Authorities. It is effectively factoring a different tax environment. Overall, we are very pleased with our portfolio. And even in the more conservative scenario, it will have a very marginal effect. But as you know, when you have the consultation there is work that needs to be done. The data that is going to be in there from talking to the regulator, and we will just be working together with their down [list]. I think the overall message we like very much our portfolio, and this will not have a significant effect in any shape or form.

Operator

Our next question comes from the line of Enrico Bartoli.



Enrico Bartoli MainFirst Bank AG, Research Division - MD

The first one is regarding your cost of debt. You highlighted some measures that you took in the first half in order to optimize the cost of debt. If you can spend some words regarding the further potential that you have, considering the current interest rate environment. And in particular, I was wondering during the presentation of business plan, you had an indication of an average 1.8% cost of debt over the plan period, considering the [Federal court] at that time, if it's possible to have some sensitivity considering -- of this number, considering the current interest rate environment. Second question is regarding DESFA. Now that actually the new return has been set, we have more visibility on the regulation, I was wondering if you have updated or can give us some more visibility on the CapEx plan of the company and on the possible RAB evolution over the next years? And the last one is regarding the evolution of the other businesses, those related to energy efficiency and energy transition. If you can elaborate a bit on the evolution in the first half. So I guess that probably EBITDA would be still negative due to start-up. If you can share us how you see the evolution of their contribution and where we can see those -- that contribution at the breakeven?

Marco Alverà Snam S.p.A. - CEO & Director

Okay. Thanks, Enrico. I will start with the last 2 and then Ale, you can talk about the forward curve and the cost of debt. So on DESFA, we will talk -- we are in the process of working on its first business plan post-acquisition and on the 10-year plan as well. There's a new government in place, and we will provide a full update on that in the context of our new plan. I would say, that will also be the time when we will get more visibility on the progress on the new businesses. You're right in indicating that the contribution of EBITDA is marginal on some businesses and negative on one of the businesses, which is fully in line with our plan. We're satisfied with the trend and the growth that we're seeing in these businesses. And we are seeing a lot of traction on the energy efficiency side, where the pipeline that we have built is much greater than what we had expected. But again, we will give you a full update when we talk about this business in the context of the new plan. Ale, do you want to talk about the cost of debt.

Alessandra Pasini Snam S.p.A. - CFO

On cost of debt, I think, overall, the interest charges were EUR 85 million for the first half. I've been saying that given the current market environment, that's a good number for the full year. But we will continue to optimize and -- our [treasury] management as long as the market remains in this shape of level when it comes to our short-term funding needs. And we will be opportunistic vis-à-vis additional funding effectively corresponding for 2020, which may have a marginal negative effect in terms of cost of carry on what we have seen



for the first half, where we had one rollover. And we will continue to be very vigil on possible optimization of our debt structure, as we've done towards the end of last year. I think that this will be the plan. Let me -- we don't want to get into long-term guidance on market sets. But if we take the forward cost today versus what we had in November, it has gone down, let's say, around 100 basis points and private spreads have shrank by around, call it, [50] basis points. You can assume that our 1.8 was factoring dips in market. We need to get significant market conditions. Today, it would be a lower number, and again, we're not getting into long-term target targets and guidance.

OPERATOR

And our question comes from the line of Anna Maria Scaglia.

Anna Maria Scaglia Morgan Stanley, Research Division - Research Analyst

Just a very quick one on my side. If I put together the comments that were made on the guidance and the EUR 20 million and the one-off, this seems to imply that there is a EUR 15 million overall increase in the guidance for the future years. Given that I would assume that the benefit of the lower cost of debt is going to stay and there is some improvement in France, that is going to stay, unless the regulation is nothing really worse. Is that correct?

Marco Alverà Snam S.p.A. - CEO & Director

Anna Maria, just to be -- I think, just for simplicity, you should consider structural the financing related to the cost of debt-related points. As we look at the associates, with the exception of some of the DESFA positives, which, by the way, have more to do with the improved outlook in -- as we look at the value of this acquisition with the improvement in the Greek macroeconomic outlook for risk-adjusted returns on this. But you don't see here is much improved. And there is some improvement also on the recurring contribution from that business. But for your purposes, I would look at the reduced cost of debt as we can stretch out into the future.

Operator

And our next question comes from the line of Stefano Gamberini.



Stefano Gamberini Equita SIM S.p.A., Research Division - Analyst

A few questions, if I may. First of all, regarding the M&A, could you update us what is the situation regarding new acquisition in the M&A and other activities that could we expect in the forthcoming years? And if you are also starting some new initiatives on that side? This is my question.

Marco Alverà Snam S.p.A. - CEO & Director

Okay. On biomethane, I don't know, if you call it M&A, these are very small projects. As you know, we've acquired a small company in (inaudible) that builds the biomethane plant, which we think has helped accelerate the market. As I mentioned earlier, we have a number of connections already to our plants. And we are evaluating the acquisition of specific plants in partnership with local agriculture producers or waste management producers. So this was a business that, it's more about organic growth and maybe both of these are very small investments that have a interesting return, have regulated type incentive. And as we said previously, if we're involved in the whole value chain, including CNG, we see the opportunity of bringing 100% renewable gas into vehicles and into trucks, not only as the way to maximize the incentive, but also the way to begin promoting our own network that's becoming [united].

Stefano Gamberini Equita SIM S.p.A., Research Division - Analyst

And if I can just add another one regarding the regulation, where we expect some update regarding the auto basin centers that should arrive for gas transport, if you have some talk with the regulator?

Marco Alverà Snam S.p.A. - CEO & Director

We have ongoing discussions. As you have seen in the results, there is already quite significant growth in the output-based incentive on the balancing. We expect throughout the fifth regulatory period, we will have gradual and increasing profits deriving from this activity. Really around the 4 issues that we discussed previously around safety, around the markets and how to facilitate market interconnections and developments of new markets. And third, around the environment and how we can be incentivized to favor decarbonization and then around service quality. So they would be introduced gradually throughout this regulatory period.



Operator

And our next question comes from the line of Emanuele Oggioni.

Emanuele Oggioni Banca Akros S.p.A., Research Division - Analyst

I ask you the -- an update, if you could provide us an update on the ongoing discussion on about the coal phase out in Italy by 2025. Also related as regards this matter, the Sardinia methanization. Could you provide us an update? And eventually a delay could -- how could impact on your business plan?

Marco Alverà Snam S.p.A. - CEO & Director

By the way, did you ask about Sardinia?

Emanuele Oggioni Banca Akros S.p.A., Research Division - Analyst

Yes. The coal phase out in Italy by 2025 is the ongoing discussion point for a delay actually. And then also related to the Sardinia methanization.

Marco Alverà Snam S.p.A. - CEO & Director

Okay. I got it, right. So on the first point, and the phase out, we understand is going ahead. We have been asked by current coal producers to study the interconnection to our grid of these plants. The timing is tight. The commitment is there. And from what we see in the discussions we have, we -- it's going to happen. So that will have a positive impact on gas demand and network buildouts. Coming to Sardinia, I had recently met with the governor there, and we both agreed to press ahead quickly. They have a sense of urgency to achieve methanization because of, not only the environmental benefits of gas over GPL, but there's very significant cost advantages.

Today on a wholesale level, GPL can cost 3x more than methane. So the cost-benefit analysis for the methanization of Sardinia is very robust. Because for the heating and for the residential as well as those industries that use GPL for heating in hotels, the cost advantage is very significant as well as the environmental advantage. So this is already included in our plan. We have a joint venture with such (inaudible), SGE, and we're working on the permitting for this. And it's progressing.



Operator

Thank you. There are no further questions at this time.

Marco Alverà Snam S.p.A. - CEO & Director

Okay. Thank you very much.

OPERATOR

Thank you. That does conclude our conference for today. Thank you for participating. You may all disconnect.

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