

ERG S.p.A.
“Third Quarter 2016 Results”
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MODERATORS:
LUCA BETTONTE, GROUP CEO
PAOLO MERLI, GROUP CFO

Operator:

Good afternoon. This is the Chorus Call conference operator. Welcome and thank you for joining the ERG Third Quarter 2016 Results Conference Call. After the presentation, there will be an opportunity to ask questions. At this time, I would like to turn the conference over to Mr. Luca Bettonte, CEO of ERG. Please go ahead Sir.

Luca Bettonte:

Good morning and thanks for coming to this conference call related to our third quarter results. Here with me is the CFO, Paolo Merli.

We start by underlining our key figures for the period, as per **page no. 4**. We posted overall good results, despite a weak price scenario in particular in Italy and Poland.

In Italy the Average National Price (the so-called PUN) went down to 41€/MWh in the 3Q16 - from 57€/MWh in the 3Q15 (-16€/MWh) - and went down to 38€/MWh in the 9M16, from 52€/MWh in the 9M15 (-14€/MWh). While electricity demand on a YoY basis in Italy posted a -3.1% on 9-months, and a -5.0% on 3-months.

In Poland due to the regulatory uncertainty sale prices - including the Origination Certificates - went down from €62/MWh to €40/MWh (-22€/MWh).

Anyhow, before going through any specific item it is worth underlining the big difference in terms of installed capacity between 2016 and 2015, as at September 30, 2016 we had: 266MW of larger wind capacity abroad, 8MW of larger wind capacity in Italy, and 527MW of new hydro capacity in Italy.

Now I make some comments on the 3Q16 on YoY basis.

EBITDA came in at €78mn vs €66mn, so +18% vs last year, showing a different trend for the two business lines: €43mn vs €45mn in non-programmable (i.e. just Wind), and €36mn vs €27mn in programmable, meaning CCGT plus Hydro.

In the Wind business the slight decrease vs last year has been mainly due to the drop of the energy prices and incentives, in particular in Italy and in Poland. Electric energy generation was some 54GWh higher than last year (stemming from the larger installed capacity), but not enough to offset the mentioned strong negative price trend.

In programmable sources, the gas-fired turbine plant posted an EBITDA of €19mn, lower than €27mn of the previous year. To understand this performance it is necessary to consider that it is affected by the phase-out from the so-called Essential Units Regime, and by the Energy Management activity for the whole Group. In fact with respect to the Essential Unit Regime it is worth underlining that the connection between Sicily and the Mainland started operating at the end of May, so the 3Q15 benefited from a larger (about some €18mn) amount of fixed costs reimbursement. Net of this item, the EBITDA has benefited from:

- the Sicilian energy price, higher than last year due to the fine tuning made in this quarter by the TSO of the cable-connector with the Mainland (+€4mn)
- the contribution of MSD activities (+€2mn), resumed after the end of Essential Units Regime
- the contribution from Energy Management activities (+€2mn), and
- lower operating costs (+€2mn).

The Hydro plant contribution amounted to some €17mn (almost in line with the performance posted in the previous two quarters on a row), which is quite good taking into account the usual low seasonality for the hydro generation in summer.

Moving on to Net Profit, the 3Q16 result was at +€9mn, down vs +€19mn in 3Q15. The main reason has to do with the low seasonality of the power production in 3Q from non-programmable sources, associated with:

- higher depreciation, due to a larger asset base charged evenly in the profit and loss over the quarters (-€24mn), and
- higher financial charges (-€4mn), due to increased average net debt as a result of the huge investments made, although gross debt cost was lower than in 3Q15.

Anyhow one should consider the 9-months as a more appropriate timeframe to understand the Net Profit outcome: so far this year the result has been €83mn vs €76mn, being affected by lower taxes, due to the tax allowances from capital contribution (the so-called ACE), and benefitting from TotalERG €11mn equity value contribution, as referred to ERG's stake.

So in the end, comparing 9M16 with 9M15, EBITDA came in at €351mn vs €264mn (+33% vs last year), with an EBITDA margin of 46% vs 37% of last year. The reasons why we achieved such a strong growth are the same of the already commented YoY better performance, with the only difference stemming from the higher production in Wind and Hydro in the 1H16 due to seasonality effects. Finally, please consider that during the 9M15 the fixed costs reimbursement from the application of the so-called Essential Units Regime was some €24mn higher than in 2016.

Talking about indebtedness, Net debt grew from about €1.45bn at the end of 2015 to about €1.67bn, less than expected. This increase is attributable to:

- the acquisitions made in the Wind business: IMPAX (in France and Germany) for €292mn, and Brockaghboy's shares (in Northern Ireland, United Kingdom) for about €14mn, and
- the dividend distribution for about €143mn.

Net cash generation year-to-date (before M&A transactions and dividend distribution) is about €263mn, as the Group assets performance keep on generating cash to deleverage.

As I said, in 2016 we have been focusing on the consolidation process of all the huge amount of investments made in the previous year. As summarized on **page no. 5**, we are undergoing a profound turnaround of the existing Group structure and organization, in order to make our model more consistent with the new core business of ERG, that is nowadays a European Independent Power Producer.

In this context we have launched One Company Project through which, effective from 1 January 2017, ERG Renew and its controlled entity ERG O&M are merged into ERG Power Generation, whilst ERG Services is merged into ERG.

The aim is to create a Generation and Marketing Company (GEM) – ERG Power Generation - fully owned by ERG, whose role is to run the three different but

complementary generation technologies, as well as to sell the energy produced, through a single and centralized Energy Management (EM) Department.

In ERG a new Business Development Unit is created, directly reporting to myself as CEO, along with the enhancement of the Integrated Risk Management Unit (RM), aiming respectively at boosting the business development, and supporting and controlling the Energy Management Unit.

Finally, still in ERG, most of the staff units today allocated in to the merging companies will be centralized, and a Central Procurement Department (CPD), reporting to CFO, will be created in order to exploit at best any advantage coming from the larger business dimension of the Group.

We believe this new organization will bring benefits by

- fitting better with the new core business,
- reducing the existing organization overlapping related to the use of the value creation levers,
- making the internal decision-making processes faster,
- reducing complexity and streamlining the overall way of working,
- enhancing people accountability, and
- improving efficiency and effectiveness.

As for potential synergies, we expect them to come out mainly from the new and more efficient way of working, thus exploiting at best the Business Development, Energy Management, Integrated Risk Management and Central Procurement Department, rather than from a mere cost cutting process as a part of the entire program. This re-organization is anyhow consistent with the recent history of ERG, that went through several transformation processes during the last decade.

Now I will hand you over Paolo for his analysis.

Paolo Merli:

Thanks Luca, and good morning everybody.

I will start as usual with a brief overview of the power scenario over the period, as per **page no. 7**.

The overall scenario for the Power market continues to remain quite weak: the National electricity demand in Italy was down 5% and 3% YoY in the third quarter and in the first nine months respectively. Focusing on the quarter and looking at the different sources in Italy, Wind contribution to demand was up by 11%, Hydro down 1% and Thermo down 6%. Notwithstanding those Industry data, our Wind operations - given their specific location in the country - suffered slightly weaker wind conditions in absolute terms, though a touch better than last year. Conversely, Hydro productions were much better than both our budget and last year, when the plant was out of our scope.

The Average National Price in Italy was 41€/MWh in 3Q 2016, -28% year-on-year. The quarter was still characterized by a severe downward trend in electricity prices, both in Italy and in Europe. Price indicator for Renewables in Italy, including feed-in-premium,

was 141€/MWh, -10% YoY. Price in Sicily traded at a huge premium vs. the Average National Price (13€/MWh vs 5€/MWh in 3Q15) following some operational disruptions on the cable during the period, which were over at end of September.

Generation margins were quite satisfactory in the quarter: up significantly QoQ though broadly in line YoY, as shown in the chart.

Abroad - in light of our exposure to feed-in-tariff systems in France, Germany and Bulgaria - the impact from the price scenario was limited, with the exception of Poland, where the general environment remains very challenging with sale prices (including the Origination Certificates) significantly down YoY, following the uncertainty regarding the evolution of the regulatory framework.

Notwithstanding this poor scenario, we posted good results, up YoY and slightly better than our budget.

Let us see it in a nutshell, commenting **page no. 8**. EBITDA for the period was €78mn (+18% YoY), mainly driven by the contribution from new assets, with a higher installed capacity of about 800MW in the period, of which 500MW Hydro and 300MW Wind abroad. As I mentioned, those results were achieved in a very challenging power price scenario. Continuous efforts on the central cost side also helped to sustain our profitability in the period, confirming a trend seen over the first 9 months of the year.

As stated in our Business Plan - and also consistent with the new organization which has already been described by Luca - we now rely on a much larger generation portfolio (as per **page no. 9**), directly managed by a unique Energy Management center. During the quarter, ERG managed roughly 3.1TWh of energy, of which 1.6TWh generated by our portfolio of assets. The remaining 1.5TWh was purchased on the Market in order to adjust our supply profiles and optimize the portfolio, with basically no risks taken.

As far as sales, 0.5TWh was the electricity sold through a bilateral contract to IREN, 0.1TWh to site customers, and the rest was sold on the Wholesale Market (2.2TWh in Italy and 0.2TWh abroad). In the first 9 months, our portfolio was composed of 9.1TWh, +23% YoY: a fairly sizeable portfolio.

Now Wind, I am on **page no. 10**. EBITDA was €43mn, down slightly YoY despite the larger scope with 274MW of additional installed capacity in France, Germany and Poland. The contribution of those new assets - about 86GWh in the period - was more or less off-set by:

- productions, that on a like-for-like basis, thus excluding the additions, were down by about 31GWh in the period (mainly in France, Germany and Poland) due to weaker wind conditions in western-central Europe (whilst in Italy productions were up slightly YoY by 2%), and
- weaker price scenario on a YoY basis, in particular in Italy and Poland, where all-in sale prices were down 10% and 35% respectively, as already mentioned before.

Now Programmable results (which include CCGT and Hydro) as per **page no. 11**. EBITDA was €36mn against €27mn in the third quarter of 2015.

In details, CCGT EBITDA was at €19mn vs. €27mn. The drop on a YoY basis fully reflects the exit from the “Essential Unit Regime”, which meant lower costs reimbursement for about €18mn in the quarter, after the Sorgente-Rizziconi interconnection went on stream as of May, 28. This effect was partly mitigated by:

- positive local price scenario resulting in higher spark spreads for our CCGT. Local price premium was mainly driven by some disruptions for the cable during the period, which have now been fixed.
- greater contribution from Energy Management (+€2mn)
- MSD contribution (€2mn), and
- higher efficiency of the plant with lower costs (+€2mn)

All the above resulted in a total effect of €10mn.

Hydro – which, I remind you, is included in our scope since December 1, 2015 - generated an EBITDA of €17mn in the quarter. Production was quite high at 277GWh as it was stronger than both our budget (+20%) and last year’s production (+27%), when the plant was still operated by Eon Italia, thus outside our scope.

So in general we are very satisfied with the results of our Programmable asset portfolio in the first nine months, given that 2016 started off very “dry” as regards the Hydro plant, and with the exit from the Essential Unit Regime for the CCGT plant, following the completion of the interconnection between Sicily and the Mainland.

Let us now comment on Investments. I am on **page no. 12**. Investments in the period were quite limited, with €12mn mainly concentrated in Wind (€8mn) and mainly related to the construction of Brockaghboy wind farm in Northern Ireland, which we expect to be on stream by the end of September 2017.

When looking at the first nine months, figures are more significant: ERG invested €337mn, which includes the M&A expenditure for the acquisition of wind farms in France and Germany from IMPAX Asset Management (€292mn), and what invested so far for the development of the Brockaghboy wind farm in Northern Ireland (about €30mn), including the cost for the acquisition of the project and the down-payment for the Wind Turbine Generators.

Now I am on **page no. 13**, commenting quickly TotalERG results, accounted on an equity basis. As usual, to keep it simple, I will look at results for 100% of the Company, of which 51% is ours.

EBITDA was €44mn, down 28% compared to €61mn in the third quarter of 2015. When looking at the first nine months, EBITDA was €97mn, down 15% compared to €114mn in the same period last year.

More in detail, Marketing EBITDA suffered, despite higher volumes and market share. In particular the Retail segment was hit by weaker margins, partly due to rising oil and oil product prices, which resulted in a margin squeeze at pumps, as those uplifts could not

be immediately passed onto end prices. On a company-specific basis, TotalERG Retail is still performing relatively well in this business environment.

Most of the drop in EBITDA is related to Refining operations, whose results suffered from a sharp reduction in refining margins, with the EMC indicator down from 4.0 to 1.5\$/bl, as shown in the chart.

Being an equity investment, we tend to look at Net profit. In this respect, thanks to lower depreciation (non-cash costs) and lower financial charges, TotalERG contribution to our Net Profit at replacement cost (51% of the total) in the first nine months of the year was positive (€11mn) and perfectly in line with the same period last year.

I will now comment on Profit & Loss at replacement cost, as per **page no. 15**. I have already commented on EBITDA, so going down, higher depreciation reflects the consolidation of new assets. Net Financial expenses were up YoY from €14 to €18mn (which is very good, considering the huge re-leverage of the Company), with an average NFP in the period at roughly €1.8bn, roughly 3 times more than last year (when it was about €600mn on average). As a consequence, the implied cost of Net Debt declined significantly from about 10% in the 3Q 2015 to about 4% in the 3Q 2016. This financial optimization reflects:

1. the fund raising for the acquisition of Hydro (with a cost just slightly above 1%)
2. the renegotiation of the margins for some Project Financing facilities, and
3. the pre-payment of some non-performing PF using our available cash.

All these actions allow us to further optimize our cost of ML/T debt, bringing it down from 4.3% last year to 3.4% in this quarter (-20%), which we believe is a very competitive number, also in absolute terms.

Income from Equity Investments - namely TotalERG - was €9mn in the quarter vs. €13mn last year. As already mentioned, when looking at the 9 months, that number is bang in line YoY.

Taxes: here I think it is always better to look at the tax rate in the nine months, being more representative: 24% vs. 27%, down mainly thanks to the fiscal yields granted on capital injections done in our subholdings to support financially the acquisitions of the last few years. Those capital increases at the subholding levels are enjoying tax benefits associated to existing tax rules (ACE) set to help economic growth.

As a result of all, Net Profit at replacement cost was €9mn in the quarter vs €19mn, reflecting the typical seasonality associated with the higher leverage and depreciation. Looking at the first 9 months, Net Profit was €83mn vs. €76mn in the 9M 2015, so again a significant improvement YoY, which in the end meant that the acquisitions done in 2015 are resulting earnings accretive for the Group, despite the weak price scenario.

Now the cash flow statement for the period, as per **page no. 16**. In brief, during the quarter we generated €163mn of deleverage bringing our Net Debt down to €1.67bn from €1.84bn at June 30, when we reached our peak following the M&A in Wind in Q1 and dividend in Q2, half of which - I remind - extraordinary. Well, this quarter provides

clear evidence of the capability of this Group to consistently generate cash-flow and deleverage, even exceeding the already challenging targets set out in our Business Plan and guidance.

In more detail, the net cash generation reflects the €78mn of cash EBITDA (already mentioned), working capital improvement of €114mn, mainly related to the cash-in of incentives for €136mn over the period (€105mn associated to Wind and €31mn to Hydro), €18mn of net financial charges (as already discussed), and €1mn of other effects.

Please also consider that our net financial position includes at 30th September roughly €170mn of negative fair value of IRS derivatives, which are non-cash debts, inherited from past acquisitions.

The biggest take-away here for you is that our Net Financial Position is better than the one targeted in our Business Plan, allowing us today to improve our guidance for the full year, as Luca will explain to you in a while.

I think I have touched on all the key items, so I will now hand you over to Luca for his final remarks.

Luca Bettonte:

Thanks Paolo. With respect to guidance, as you can see on **page no. 18**, we update some of them.

Not EBITDA, which is confirmed at €440mn, despite that Year-to-Date results are above our expectations and our budget, but we see just a potential thin improvement of the energy price scenario in Italy in the last quarter, that anyhow might affect mainly the northern electricity zones, to whom we are not exposed. Moreover we do not envisage any further higher production in either Wind, or in the Hydro business, for which we keep steady the budget projections for the months to come. CCGT should continue to benefit from a good spark spread, although less wide than in the 3Q16, as the issues affecting the cable have been fixed since the end of September.

CAPEX guidance is reduced at €380mn from the €400mn of 1H16, due to some delays of Brockaghboy investment spending

Net Debt is reduced at €1.65bn from the previous €1.73bn, to include the result already achieved as at September 30, and the cash generation of the 4Q16. All in all, if we deduct from the cashflow €306mn of M&A transactions, the distribution of about €143mn to shareholders (out of which half extraordinary), and investments in the U.K. for €56mn, the cashflow generated in 2016 would be at about €300mn.

Now we are ready to take your questions

Questions & Answers

Operator:

Excuse me. This is the Chorus Call Conference operator. We will now begin the questions and answers session. The first question is from Niccolò Storer with Mediobanca. Please go ahead Sir.

Niccolò Storer:

Yes, thank you for taking my question. The first one is related to your guidance in terms of EBITDA. If I look at the implied fourth quarter performance basically I just need a flat EBITDA versus last year, but we know that we have a broader perimeter, and also probably the Hydro contribution could be a little bit higher, as last year was at the very beginning of the consolidation period. So could you please give us a little bit of insight in what you have seen in October and beginning of November both in Wind and Hydro, and about Hydro tell us if the recent earthquake had any impact on the operations? The second question is related to your tax rate: basically, if I understand well, the tax benefit that you had in the quarter was related to the capital injection that you did, is this correct? And, again on tax rate, did you run any simulation on the impact on Group tax rate from 2017 onwards with a reduction over the years? Thank you.

Luca Bettonte:

Right. As far as guidance, we used to be conservative but in any case let us consider that what we see going forward has to do with the price level that we see is not going to rise that much. However even if we are going to generate much more gigawatt hours in the next month compared to last year (simply because we have more installed capacity), I think we prefer to stay as we are, also considering what happened in this quarter: in fact we increased the production, but the EBITDA was even lower in the Renewables, although just for a couple of millions. Therefore we are not increasing our EBITDA forecast for the year end.

As for the hydro plants, they are performing well. At the beginning of the year the start was not that good because it was a dry season. Now the situation is bettering and we are planning to arrive at the end of the year with a production that is going to be in line or even a bit higher than forecast. But in that region and in the central-northern region the energy price was by further lower than last year's, i.e. in the range of €10, something more than €10/MWh. That is why we want to be conservative.

You know that there are some problems in France, so that they are increasing the prices. In Italy we could benefit something from them in that region but for the time being we prefer to be focused on the production rather than on the prices, that is why we maintain our forecast. After the earthquake fortunately we did not have any damage: of course, if we had we would have made everybody aware about that, so we did not spread any press release because it was useless, because everything was working well. Our people - let me thank them - worked very hard also during the night, in order to monitor the situation. So, so far so good, let us hope - mainly for the people living there - that everything is finished, and that we can live again a quiet and calm life.

Moving to the tax rate, you are right: the ACE benefit is what affected mainly the outcome of this third quarter; you know that going forward to the next year maybe someone could try to cut in half the rate, the ACE rate so the benefit could be lower, in any case let me tell you that you can take in your account on average something between 25% and 30% of tax rate going forward, and that could be in any case in line also with the reduction for the future.

Niccolò Storer:

Thank you.

Operator:

The next question is from Roberto Letizia with Equita. Please go ahead.

Roberto Letizia:

Yes, good morning. The first question is on the deal with UniCredit: considering that you have used the own shares for the deal and considering that you already approved another buyback program this year, should we consider as a real possibility that you start up in buying back your shares going forward, even in light of the share price that is depressed? The second question is again on the tax rate: can you give us the feel of what has been the ACE contribution in the quarter, because I think that, if I strip out the ACE contribution in a quarter, the underlying tax rate goes up to 40%-50% which is a very high number. So, what had the ACE contribution been in the quarter, and what had been the ACE contribution in the nine months as well? And when you talk about a 25%-30% tax rate, does this include the ACE contribution? So what could be the underlying tax rate without these positive benefits, that are reducing next year and probably will disappear going forward? Thanks a lot.

Luca Bettonte:

Yes, let me start from the bottom, so the ACE contribution was some €6 million in this quarter, and the forecast tax rate takes into account the ACE contribution for the future and the benefit at the end stage, we have no further forecast information on that point.

Roberto Letizia:

Sorry, what was the contribution in the nine months, if you have it available right now?

Paolo Merli:

€14 million.

Luca Bettonte:

€14 million. So you may take some €18-€20 million for the whole year.

Paolo Merli:

Consider that we injected roughly €1.6 billion on the few subholdings we have, which went through the acquisitions over the last few years, so it is a massive amount of money in the subholdings.

Luca Bettonte:

All right. Going back to your initial question, if I were British I would say “good question”, but being an Italian I will try to answer. So it has to do with how much money we are going to give back to the shareholders in the end, you know. As for the buyback authorization, every year we ask for a new one to the shareholder meeting and this is what shareholders used to give us. To have a buyback has to do with the financial context: so whether or not we are going to give money back to the shareholders, it depends on the investment case we have in front of us. So, as long as we are ready to invest, able to invest, we do not think to go diluting money in a buyback or in an extraordinary dividend.

So our dividend policy is confirmed as you know, and we are now introducing quite a strong, in-depth re-organization in the Group to exploit at best our knowledge and to focus our people on development. So we are generating a lot of cash, but we are still focusing on investing money in our core business, although – from a regulatory viewpoint - in Europe and also in Italy, it is not a very good moment for investments not even looking forward, particularly from 2017, based on the introduction of the auctions in France and - we hope - in the UK, and we are waiting for the repowering and the auction in Italy going forward. So we are accumulating cash in order to invest.

Roberto Letizia:

Okay. Thank you.

Operator:

The next question is from Roberto Ranieri with Banca IMI. Please go ahead.

Roberto Ranieri:

Good morning everyone. Three questions please. The first one is on the One Company project. I am just wondering when this project could contribute in terms of synergies, so if you see any synergies on it (as I suppose you do), if you have any amount of these synergies from the project and, in addition to that, if these synergies were included in your guidance for 2016 or in your budget. The second question is on the equity contributions, just a clarification: if I understood correctly, €11 million is the contribution of TotalERG in the nine months. I am just wondering what the other equity contributions are in the nine months. The last question is on net working capital reduction of €114mn: I am just wondering what the drivers are for this working capital reduction, as also you said that the working capital is expected to decrease all over the year. So is this reduction also sustainable for the fourth quarter? And do you envisage any reversal of this working capital change? Thank you very much.

Luca Bettonte:

All right. I am going to answer your first question, for the remaining two I will send you over to Paolo. Yes, on One Company: as you know, the Group went through several organizational transformations over the last decade. So, we are still in front of another one, at the end of the day. So it is something we are familiar with, you know, that flexibility and efficiency are two of the main features and main items, and main - let us say - advantages we want to have, in order to act in a world where we are small or

relatively big compared to the other peers we are working with. So, we have shown our intent to change the company, and the process already began.

In terms of synergies, we expect to see some benefits starting from next year in particular because, as you have seen in the chart, the merger process and the merger transaction will be effective starting from the 1st of January next year, although we are already working in that direction in the Group. In terms of synergy timing from next year and magnitude value based on part of the business, we are forecasting something that is probably in between €5 and €10 million. We are going to be more precise in a couple of months, by sharing with you our projections, when we discuss the guidance for 2017.

Paolo Merli:

Roberto, with reference to your second question about the revenues coming from participation, it is just related to TotalERG: despite weaker EBITDA, in the end at bottom line delivered the same net profit as last year. So, about €22 million of which €11mn are our quota, our stake. The compensations to the EBITDA is coming from lower financial charges and a lower depreciation, then resulting in the same bottom line. We do not have any other significant minority stakes.

On working capital, the answer to your question whether there is going to be some reversal in 2017 is no, in the sense that in the third quarter the cashflow was in line with our expectation: we cashed in all the green certificates generated in the fourth quarter of 2015 plus - and from this respect it is a sort of discontinuity, moving from the previous mechanism for green certificates to the new one, based on a feed-in premium tariff - we cashed in also the green certificates generated by the hydro assets and by wind assets in Italy in Q1, 2016, which was a very good quarter. So, we had roughly €136 million of incentives settled during this quarter, and no reversal is expected in 2017. Therefore we revised our guidance in terms of net financial position, which is not going to affect the cashflow going forward.

Roberto Ranieri:

Thank you.

Operator:

Mr. Bettonte, there are no more questions registered at this time.

Luca Bettonte:

Okay. Thanks a lot everybody for staying with us. I will speak to you next time for the full-year results.

Paolo Merli:

Thanks.