Fitch Affirms Telefonica, Telefonica Germany on E-Plus acquisition

Fitch Ratings-London-: 21July 2013: Fitch Ratings has affirmed Telefonica SA's (TEF) Long-term Issuer Default Rating (IDR) at 'BBB+' with Negative Outlook, and Telefonica Deutschland Holding AG's (TEF DE) Long-Term Issuer Default rating (IDR) of BBB, Outlook Stable. Both affirmations follow the announcement of the proposed acquisition of E-Plus, the mobile market number four measured by subscribers, in Germany.

The agency has also affirmed the senior unsecured rating of the bonds issued by Telefonica Europe BV, Telefonica Emisiones S.A.U at 'BBB+' Telefonica Germany GmbH & Co OHG's senior unsecured rating at 'BBB' and Telefonica Finance USA LLC's preference shares at 'BB+'. The agency has affirmed TEF's Short-term IDR at 'F2'.

The affirmation of both ratings (IDRs) reflects Fitch's view of the industrial logic of the transaction and a financial structure involving a combination of cash and equity that will preserve Telefonica's leverage profile. Management have shown prudent financial management over the past eighteen months, reducing leverage and significantly improving liquidity.

KEY RATING DRIVERS

Transaction Logic
The combination of Telefonica's German operations with E-Plus will create the country's largest mobile operator by customers and second largest by revenues. In a market currently dominated by T-Mobile and Vodafone, the consolidation of the market down to three, will in Fitch's view create a more balanced playing field, allowing the combined business the opportunity to exploit the economies of scale enjoyed by the existing incumbents. Cost synergies should come over time, with the enlarged business better placed to meet the ongoing need for network and product investment (infrastructure and spectrum related) – something that should ultimately benefit the consumer.

Positive for Telefonica Germany
While the near term impact of the transaction does not change Telefonica Germany's 'BBB' rating, it is seen as credit positive in terms of the scale and market position it would achieve. Over time cost synergies (both opex and capex) can be expected and the combined business better placed to compete with T-Mobile and Vodafone. The latter both benefit from the potential to offer full facilities-based quad-play services, nascent in other markets and not currently a feature of the German market, which could however yet prove an advantage.

Conservative Transaction Structure
In keeping with the approach that Telefonica has taken in managing its leverage profile through the eurozone crisis, the proposed transaction is structured conservatively. The combination of the equity component of the acquisition and the stronger cash flow of the enlarged German business is expected to offset any leveraging effect of the cash / debt component of the deal. Near term leverage metrics in Fitch's rating case remain largely unchanged, while cash flow generation and synergy benefits offer leverage upside further out.

There is an element of execution risk attached to some of the equity components in the proposed structure, the details of which have yet to be finalised – Fitch assumes a successful outcome to these proposals but notes an element of uncertainty will remain in the meantime.

Deleveraging & Liquidity
Fitch views management actions to improve leverage and shore up liquidity, over the past 18 – 24 months - to have been prudent and successful. While minority stake sales have helped, Fitch considers the 2012 dividend holiday and rebasing of the distribution at EUR0.75 per share, to be significant – both in terms of absolute cash preservation and the message these actions serve in prioritising debt protection.

A net debt target of below EUR47bn by YE13 is, in Fitch's view, likely to be met and the company's current liquidity largely covers maturities through 2015. EUR23bn of debt refinancing over the past 18 months underlines the company's ability to access debt markets despite the market volatility associated with a domicile in southern Europe.

Regulatory and Competition Review Hurdles
Despite the strategic logic and potential benefits to the wider market, Fitch believes the transaction could run into protracted regulatory and competition related reviews. European policy makers have voiced concerns generally over in-market consolidation, ignoring the potential benefits of a more evenly balanced and more efficiently invested market environment.

For a summary of the broader KEY RATING DRIVERS underlining the agency's Telefonica rating please refer to the RAC dated 8 April 2013.

RATING SENSITIVITIES (Telefonica SA)

Positive: Future developments that could lead to positive rating actions include:

A stabilisation of the Spanish sovereign is the single most necessary near-term event to prompt a revision of the Outlook to Stable.

Outside of sovereign linkage TEF displays strong portfolio diversification, scale and strong underlying cash flow; but its organic growth profile and ability to deleverage has stalled. Fitch would need to believe that weakness across Europe, in particular Spain, will not inhibit further deleveraging and evidence of the company's ability to continue to finance itself despite eurozone pressures, would also be expected, before the Outlook was revised to Stable.

Negative: Future developments that could lead to negative rating action include:

Funds from operations (FFO) net leverage of 3.19x in 2012 remains high for the rating but heading in the right direction. Fitch's rating case forecasts a metric trending towards 3.0x by YE13, which is consistent with the current ratings. High single digit pre-dividend free cash flow to sales is also expected at the rating level. Metrics expected to remain consistently outside these levels are likely to lead to a downgrade, with TEF currently having limited ratings headroom.

A downgrade of the Spanish sovereign to below ‘BB+’ would be likely to result in an immediate downgrade. If the sovereign was downgraded to ‘BB+’ Fitch would consider the implications for funding costs and market access for Spanish corporates and the company’s prevailing liquidity, while recognising TEF’s solid geographic diversification.

RATING SENSITIVITIES (Telefonica Deutschland)

Positive: Future developments that could lead to positive rating actions include:

Given the company’s current operational profile – somewhat limited scale and single geography presence – the ratings sit most comfortably at the ‘BBB’ level. While the financial profile compares well with the ‘BBB’ peer group, a higher rated single market operator would be expected to have a materially stronger (market number one or two) business position in turn resulting in a considerably stronger margin profile.

Negative: Future developments that could lead to negative rating action include:

A material weakening in the company’s financial profile – driven either by operating performance or a change in financial policies - would pressure the ratings. Financial metrics likely to exert ratings pressure include:

- FFO net adjusted leverage above 3.0x, and
- FFO fixed charge cover below 4.0x

Contact:

Principal Analyst
Giovanni Reichenbach
Associate Director
+44 20 3530 1255

Supervisory Analyst
Stuart Reid
Senior Director
+44 20 3530 1085
Fitch Ratings Limited
30 North Colonnade
London E14 5GN

Committee Chairperson
Mike Dunning
Managing Director

+44 20 3530 1178

Additional information is available on www.fitchratings.com. For regulatory purposes in various jurisdictions, the supervisory analyst named above is deemed to be the primary analyst for this issuer; the principal analyst is deemed to be the secondary.

Applicable criteria, 'Corporate Rating Methodology', dated 8 August 2012; 'Rating Telecom Companies', dated 9 August 2012, are available on www.fitchratings.com.

Related Research: '2013 Outlook: European Telecoms & Cable'. Dated 11 December 2012.