Telefonica Deutschland Holding AG

Update

Ratings

Long-Term IDR	BBB

O2 Telefonica Deutschland Finanzierungs GmbH

Senior unsecured	BBB

Telefonica Germany GmbH & Co OHG

Senior unsecured	BBB

Outlooks

Foreign-Currency Long-Term Rating	Stable

Financial Data

Telefonica Deutschland Holding AG

	31Dec 14	31 Dec 13
Revenue (EURm)	5,522	4,914
Operating EBITDA EUR(m)	1,088	1,161
Operating EBITDA margin (%)	19.70	23.63
Funds from operations (EURm)	1,051	1,142
Cash flow from operations (EURm)	1,812	1,270
Free cash flow (EURm)	189	103
Free cash flow margin (%)	3.42	2.10
Total debt with equity credit (EURm)	2,415	1,448
FFO adjusted net leverage (x)	2.71	2.31
FFO fixed charge cover (x)	3.42	2.11

Related Research

German Telecoms Dashboard 2H15 (October 2015)

2016 Outlook: Western European Telecoms and Cable (December 2015)

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Key Rating Drivers

Integration On-Track: Telefonica Deutschland Holding AG (TEF DE) has so far managed the process of integrating two divergent brands, and amalgamating two national infrastructures and retail channels efficiently, despite the challenges involved. Operational trends, measured by customer base and market share stability, LTE penetration, data usage and average revenue per user (ARPU), indicate that consumer experience is being managed well, while cost-cutting has been effective.

2015 Guidance Upgraded: Financial synergies are ahead of plan with the company achieving in year one 35% of the planned EUR800m synergies (over five years), versus an original target of 30%. EBITDA and capex guidance for 2015 were both upgraded at the 9M15 results announcement, with EBITDA growth revised from above 10% to 15% to 20%. Fitch Ratings expects the upgrade to lead to stronger near-term free cash flow (FCF) generation, although management has not revised its medium term expectations.

Stabilising and Rational Market: Fitch estimates total German mobile market revenues (excluding MVNO retail revenues) continue to decline at low single-digit rates (as at 3Q15). Market stabilisation is in Fitch's view likely given the underlying trends. In mobile, margin expansion across the market is reflecting a more rational approach to reduced handset subsidies, while smartphone and LTE penetration are driving data usage, which we expect to lead to mobile service revenue growth over time.

TEF DE has moderately improved its market position, despite integration challenges, at a time when the competition will have sought to exploit the disruption caused by the merger.

Financial Policy, Operating Leases: TEF DE's ratings are also driven by financial policy and a high level of operating leases. Fitch views management as disciplined and consistent in its financial policies, with a stated leverage (reported net debt/EBITDA) target of below 1.0x (9M15: 0.9x). Dividend policy is clear with management committed to a payout which is progressive, but which takes into account ongoing investment needs, including the likelihood of capex remaining high for the next two years.

Operating lease and handset receivable adjustments currently add an estimated 1.9x to 2.0x to the unadjusted (net debt/EBITDA) measure of leverage – our base case envisages FFO adjusted net leverage peaking at 3.0x in 2015 and that the metric will decline as FCF expands and leases are reduced, given the benefit of network rationalisation.

Limited Content Risk: There is a market for quad-play in Germany – Deutsche Telekom for instance, has 2.6m IPTV/satellite subscribers – but Fitch does not view the German market like the UK where pay TV has become a compelling part of the telecoms offer. Data usage on mobile is being driven by content – music, social media and video. Fitch understands revenue-share agreements with content providers are profitable, but takes the view these services are as important in terms of driving data usage and ultimately improving ARPU.

Rating Sensitivities

Leverage and Operational Performance: Along with ongoing operational performance and integration progress an upgrade is likely if FFO lease adjusted net leverage is expected to remain consistently around 2.5x or below. Conversely, a downgrade is likely if FFO lease adjusted net leverage is expected to remain consistently above 3.25x, and FFO fixed charge cover weaker than 4.0x.

Peer Group

Issuer	Country
BBB	
BT Group plc	United Kingdom
BBB-	
Royal KPN N.V.	Netherlands
Telecom Italia SpA	Italy
TDC A/S	Denmark

Issuer Rating History

Date	LT IDR (FC)	Outlook/ Watch
21 Dec 15	BBB	Stable
3 Jun 15	BBB	Stable
1 Dec 14	BBB	Stable
14 Jan 14	BBB	Stable
23 Jul 13	BBB	Stable
13 Mar 13	BBB	Stable
16 Jan 13	BBB	Stable

Snapshot Profile: Major Issuer-Specific Rating Factors and Trends

Rating factor	Status[a]	Trend
Operations	Average	Improving
Market position	Average	Neutral
Finances	Average	Neutral
Governance	Average	Neutral
Geography	Average	Neutral

[a] Relative to peer group
Source: Fitch

Related Criteria

Corporate Rating Methodology (August 2015)

Immediate Peer Group – Comparative Analysis

Sector Characteristics

Operating Risks

Incumbent telecom operators have mature but relatively stable cash flows in their home markets. In most cases this is complemented by a degree of diversification, developed either in adjacent or emerging markets. Domestic market growth is mature, both in fixed and mobile segments, where market saturation and competition make further subscriber growth difficult.

Financial Risks

The financial performance of European telecoms markets is gradually improving. Continued improvement in EBITDA is key as capex may still remain high as operators continue to upgrade their networks. Further content investment, especially for live sports broadcast rights necessary to compete in the pay-TV segment is a risk in some markets.

Peer Group

LTM June 2015 (as reported)	Telefonica Deutschland BBB/Stable[a]	BT Group plc BBB/Positive[b]	TDC BBB-/Stable[b]	KPN BBB-/Positive
Revenue (EURm)	7,870	23.996	3,239	7,243
Underlying revenue growth (%)	n/a	-2.3	3.4	-7.2
EBITDA margin (%)	19.7	35.4	41.0	33.1
Net debt/EBITDA (x)	1.48	0.93	2.8	3.06

[a] Includes pro-forma estimates for combined Telefonica Deutschland and E-Plus businesses.
[b] EUR/DKK = 7.45
GBP/EUR = 1.35

Source: Fitch, companies

Key Credit Characteristics

Increased 4G and fibre coverage is increasing the utility and availability of high-speed broadband networks. This enables operators to offer improved bundles with higher value for an increased fee. The adoption of these bundles should strengthen average revenue per user. Regulatory pressures from the past few years have been largely absorbed, along with the erosion of voice and SMS revenue. Several major European markets have seen in-country consolidation. As a result, pricing appears to have become more rational.

Overview of Companies

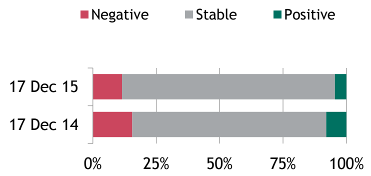
Telefonica Deutschland Holding AG (BBB/Stable) – is Germany's mobile market number one by customers/number two by service revenues, following the E-Plus merger in 4Q14. Network integration in the coming years will generate important cost synergies while LTE rollout should support the company's infrastructure and competitive positioning.

BT Group plc (BBB/Positive) – is the UK incumbent telecom. Operating in a highly competitive market, the company's investment in fibre and TV content (primarily sport) supports the company's market number-one broadband position. Strong cost management, good cash flow and low leverage support its ratings and Outlook.

TDC A/S (BBB-/Stable) – is the Danish incumbent, with a strong domestic position in a mature market, but is facing intense competitive and regulatory pressure in its domestic business. Recent declines in consumer mobile and business segments as well as the loss of wholesale revenues have led to a downgrade from 'BBB' to 'BBB-'.

Royal KPN N.V. (BBB−/Positive) – is the Dutch incumbent with a leading market position in the Netherlands. The ratings have been previously weakened by intensifying domestic competition with significant market share loss to cable operators. Improving operational trends and the sale of its Belgian mobile subsidiary have triggered a change in Outlook to Positive.

Distribution of Sector Outlooks
Directional Outlooks and Rating Watches



Fitch's expectations are based on the agency's internally produced, conservative rating case forecasts. They do not represent the forecasts of rated issuers individually or in aggregate. Key Fitch forecast assumptions include:

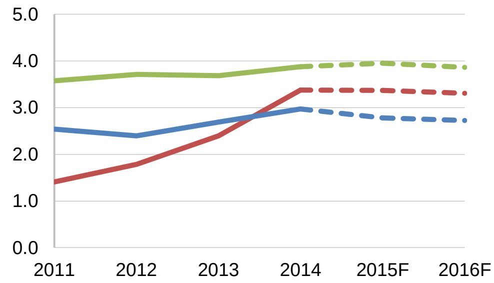
- EBITDA before restructuring of EUR1.7bn in 2015, exceeding EUR2.0bn in 2018;
- rent expense falling from EUR600m in 2015 to EUR540m from 2018;
- no cash tax before 2020;
- neutral working capital in 2015, thereafter negative change in working capital impact of EUR400m spread over 2016-2018;
- non-recurring cash integration costs of EUR577m incurred during 2015 to 2018;
- capex (excluding spectrum) above EUR1.0bn through 2018;
- cash dividends of EUR714m in 2015, flat in cash terms in 2016; growth thereafter as FCF expands.

Definitions

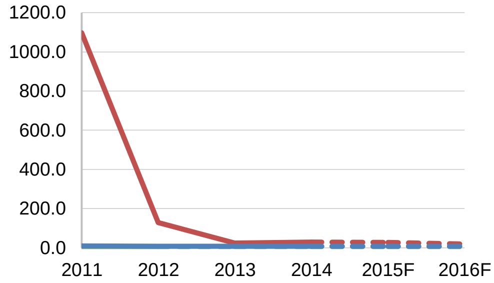
- Leverage: Gross debt plus lease adjustment minus equity credit for hybrid instruments plus preferred stock divided by FFO plus gross interest paid minus interest received plus preferred dividends plus rental expense.
- Interest cover: FFO plus gross interest paid minus interest received plus preferred dividends divided by gross interest paid plus preferred dividends.
- FFO profitability: FFO divided by revenue.
- For further discussion of the interpretation of the tables and graphs in this report see Fitch's "*Interpreting the New EMEA and Asia-Pacific Corporates Credit Update Format*" Special Report, dated 25 November 2009 and available at www.fitchratings.com.

Telefonica Deutschland Holding AG — Telecommunications Median — Developed BBB Median
Source: Company data; Fitch

Leverage
including Fitch expectations



Interest Cover
including Fitch expectations

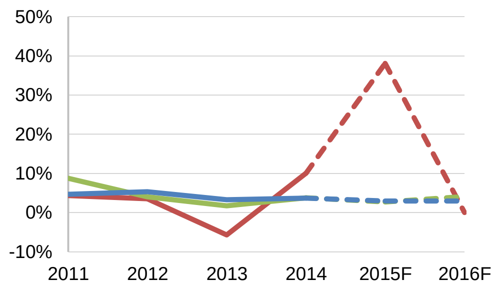


Debt Maturities and Liquidity at 30 Sep 15

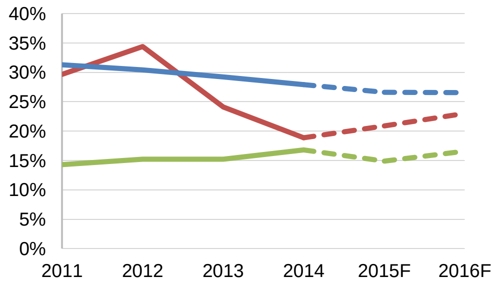
Debt maturities	(EURm)
2015	0
2016	250
2017	250
2018	600
After 2018	800
Cash and equivalents	199
Undrawn committed facilities	
Bilateral bank lines totalling EUR760m	760

Source: Fitch

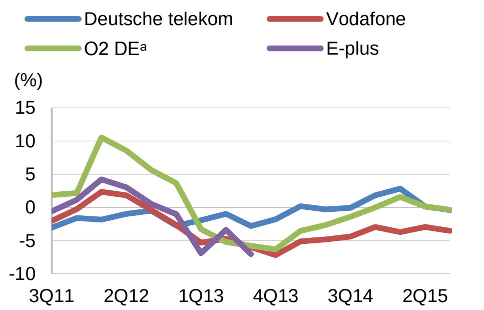
Revenue Growth
including Fitch expectations



FFO Profitability
including Fitch expectations

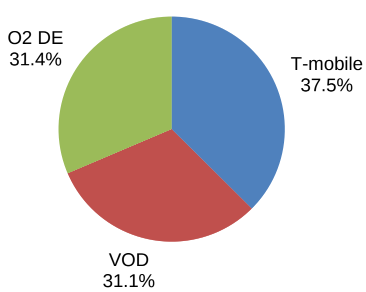


Mobile Service Revenue YoY



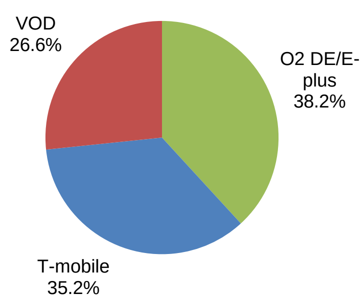
[a] Growth figures calculated on pro-forma basis for E-Plus acquisition from 4Q14
Source: Company information, Fitch estimates

German Mobile Service Revenue Market Share - 3Q15



Source: Company information, Fitch estimates

German Mobile Subscriber Market Share - 3Q15

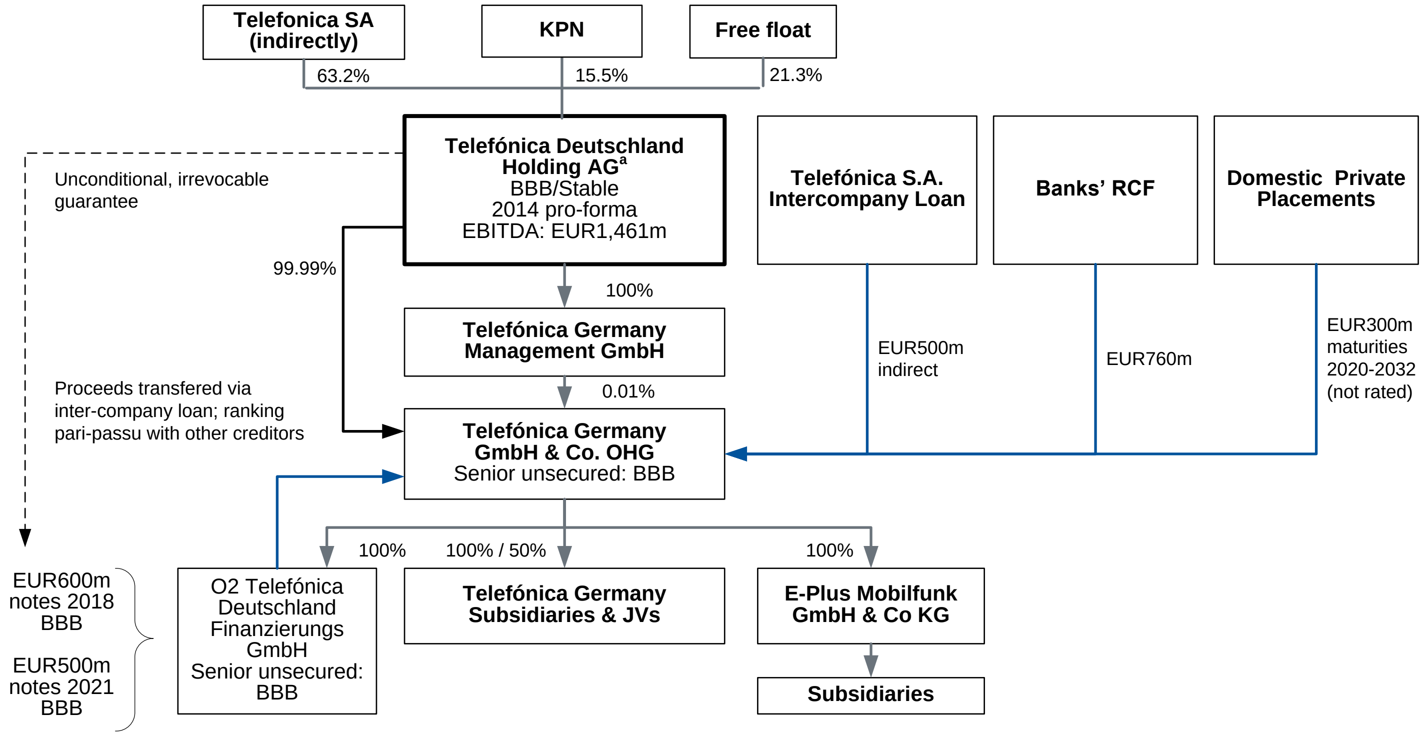


Source: Company information, Fitch estimates

Telefonica Deutschland Holding AG
FINANCIAL SUMMARY

	31 Dec 2014 EURm Year End	31 Dec 2013 EURm Year End	31 Dec 2012 EURm Year End	31 Dec 2011 EURm Year End
Profitability				
Revenue	5,522	4,914	5,213	5,036
Revenue Growth (%)	12.38	(5.74)	3.52	4.34
Operating EBIT	(237)	29	143	67
Operating EBITDA	1,088	1,161	1,279	1,154
Operating EBITDA Margin (%)	19.70	23.63	24.54	22.91
FFO Return on Adjusted Capital (%)	8.81	14.86	20.79	12.22
Free Cash Flow Margin (%)	3.42	2.11	(62.87)	20.78
Coverages (x)				
FFO Gross Interest Coverage	26.39	41.26	129.06	1,096.09
Operating EBITDA/Gross Interest Expense	26.54	41.17	92.22	854.02
FFO Fixed Charge Coverage (inc. Rents)	3.27	4.07	6.45	5.69
FCF Debt-Service Coverage	0.35	1.00	(12.14)	154.20
Cash Flow from Operations/Capital Expenditures	2.63	1.91	2.75	2.91
Debt Leverage of Cash Flow (x)				
Total Debt with Equity Credit/Operating EBITDA	2.22	1.25	0.99	0.01
Total Debt Less Unrestricted Cash/Operating EBITDA	0.66	0.64	0.73	(1.16)
Debt Leverage Including Rentals (x)				
Annual hire lease rent costs for long-term assets (reported and/or estimate)	418	341	312	314
Gross Lease Adjusted Debt/Operating EBITDAR	3.82	2.78	2.36	1.72
Gross Lease Adjusted Debt /FFO+Int+Rentals	3.84	2.78	1.79	1.41
FFO Adjusted Net Leverage	2.71	2.31	1.63	0.65
FCF/Lease Adjusted Debt (%)	3.28	2.48	(87.20)	41.49
Debt Leverage Including Leases and Pension Adjustment (x)				
Pension and Lease Adjusted Debt /EBITDAR + Pension Cost	3.82	2.78	2.36	1.72
Balance Sheet Summary				
Readily Available Cash	1,702	709	324	1,351
Restricted/Not Readily Available Cash	n.a.	n.a.	n.a.	n.a.
Short-Term Debt	615	104	255	5
Long-Term Senior Debt	1,800	1,344	1,005	6
Subordinated debt	n.a.	n.a.	n.a.	n.a.
Equity Credit	n.a.	n.a.	n.a.	n.a.
Total Debt with Equity Credit	2,415	1,448	1,260	12
Off-Balance-Sheet Debt	3,344	2,730	2,498	2,510
Lease-Adjusted Debt	5,759	4,178	3,758	2,522
Fitch- identified Pension Deficit	n.a.	n.a.	n.a.	n.a.
Pension Adjusted Debt	5,759	4,178	3,758	2,522
Cash Flow Summary				
Operating EBITDA	1,088	1,161	1,279	1,154
Gross Cash Interest Expense	(41)	(28)	(14)	(1)
Cash Tax	(6)	n.a.	n.a.	n.a.
Associate Dividends	n.a.	n.a.	n.a.	n.a.
Other Items before FFO (incl. interest receivable)	10	10	527	341
Funds from Operations	**1,051**	**1,142**	**1,792**	**1,493**
Change in Working Capital	761	128	(160)	101
Cash Flow from Operations	**1,812**	**1,270**	**1,632**	**1,595**
Total Non-Operating/Non-Recurring Cash Flow	(409)	n.a.	(15)	n.a.
Capital Expenditures	(689)	(664)	(594)	(548)
Dividends Paid	(525)	(503)	(4,300)	n.a.
Free Cash Flow	**189**	**103**	**(3,277)**	**1,046**
Net (Acquisitions)/Divestitures	(3,238)	69	559	3
Net Equity Proceeds/(Buyback)	3,620	0	0	0
Other Cash Flow Items	(954)	25	443	100
Total Change in Net Debt	(383)	197	(2,275)	1,150
Working Capital				
Accounts Receivable Days	78	63	67	86
Inventory Days	16	17	14	14
Accounts Payable Days	234	81	63	110

Simplified Group Structure Diagram



[a] Ownership as at 1 Jan 2016
Source: Fitch, Company

Figure 1

Telefonica Deutschland Holding AG — Forecast Financial Information

	Historical			Fitch forecast		
(EURm)	**31 Dec 12**	**31 Dec 13**	**31 Dec 14**	**31 Dec 15**	**31 Dec 16**	**31 Dec 17**
Summary income statement						
Gross revenue	5,213	4,914	5,522	7,628	7,626	7,663
Revenue growth (%)	3.5	-5.7	12.4	38.1	0.0	0.5
Operating EBITDA	1,279	1,161	1,088	1,704	1,896	2,012
Operating EBITDA margin (%)	24.5	23.6	19.7	22.3	24.9	26.3
Operating EBITDAR	1,591	1,502	1,506	2,304	2,476	2,572
Operating EBITDAR margin (%)	30.5	30.6	27.3	30.2	32.5	33.6
Operating EBIT	143	29	-237	-280	-49	58
Operating EBIT margin (%)	2.7	0.6	-4.3	-3.7	-0.6	0.8
Gross interest expense	-21	-33	-50	61	93	114
Pretax income	1,164	2	-581	-579	-366	-153
Summary balance sheet						
Readily available cash	324	709	1,702	729	665	224
Total debt with equity credit	1,260	1,448	2,415	2,801	3,383	3,319
Total adjusted debt with equity credit	3,758	4,178	5,759	7,601	8,023	7,799
Net debt	936	739	713	2,072	2,718	3,095
Summary cash flow statement						
Operating EBITDA	1,279	1,161	1,088	1,704	1,896	2,012
Cash interest	-14	-28	-41	-61	-93	-114
Implied interest cost (%)	1.1	2.1	2.1	2.3	3.0	3.4
Cash tax			-6	0	0	0
Associate dividends less distributions to NCI				0	0	0
Other items before FFO	527	10	10	-50	-50	-50
Funds flow from operations	1,792	1,142	1,051	1,593	1,753	1,848
FFO margin (%)	34.4	23.2	19.0	20.9	23.0	24.1
Change in working capital	-160	128	761	0	-150	-150
Cash flow from operations (Fitch defined)	1,632	1,270	1,812	1,593	1,603	1,698
Total non-operating/non-recurring cash flow	-15		-409	-239	-224	-97
Capital expenditure	-594	-664	-689	-1,023	-1,200	-1,100
Capital intensity (capex/revenue) (%)	11.4	13.5	12.5	13.4	15.7	14.4
Common dividends/cash interest on shareholder loan	-4,300	-503	-525	-714	-714	-768
Net acquisitions & divestitures	559	69	-3,238	0	0	0
Capex, dividends, acquisitions & oth. items before FCF	-4,350	-1,098	-4,861	-1,976	-2,138	-1,953
Free cash flow after acquisitions & divestitures	-2,718	173	-3,049	-383	-535	-266
Free cash flow margin (after net acquisitions) margin (%)	-52.1	3.5	-55.2	-5.0	-7.0	-3.5
Other investing and financing cash flow items	443	25	-954	-976	-111	-111
Net debt proceeds	1,248	188	1,376	386	582	-64
Net equity proceeds	0	0	3,620	0	0	0
Total change in cash	-1,027	385	993	-973	-64	-441
Coverage ratios (x)						
FFO interest coverage	129.1	41.3	26.4	27.2	19.9	17.2
FFO fixed charge coverage	6.4	4.1	3.3	3.4	3.6	3.7
Operating EBITDAR/gross interest expense + rents	4.9	4.1	3.3	3.5	3.7	3.8
Operating EBITDA/gross interest expense	92.2	41.2	26.5	28.0	20.4	17.6
Leverage ratios (x)						
Total adjusted debt/operating EBITDAR	2.4	2.8	3.8	3.3	3.2	3.0
Total adjusted net debt/operating EBITDAR	2.2	2.3	2.7	3.0	3.0	2.9
Total debt with equity credit/operating EBITDA	1.0	1.2	2.2	1.6	1.8	1.7
FFO adjusted leverage	1.8	2.8	3.8	3.4	3.3	3.1
FFO adjusted net leverage	1.6	2.3	2.7	3.0	3.0	3.0

How to interpret the forecast presented

The forecast presented is based on the agency's internally produced, conservative rating case forecast. It does not represent the forecast of the rated issuer. The forecast set out above is only one component used by Fitch to assign a rating or determine a rating outlook, and the information in the forecast reflects material but not exhaustive elements of Fitch's rating assumptions for the issuer's financial performance. As such, it cannot be used to establish a rating, and it should not be relied on for that purpose. Fitch's forecasts are constructed using a proprietary internal forecasting tool, which employs Fitch's own assumptions on operating and financial performance that may not reflect the assumptions that you would make. Fitch's own definitions of financial terms such as EBITDA, debt or free cash flow may differ from your own such definitions. Fitch may be granted access, from time to time, to confidential information on certain elements of the issuer's forward planning. Certain elements of such information may be omitted from this forecast, even where they are included in Fitch's own internal deliberations, where Fitch, at its sole discretion, considers the data may be potentially sensitive in a commercial, legal or regulatory context. The forecast (as with the entirety of this report) is produced strictly subject to the disclaimers set out at the end of this report. Fitch may update the forecast in future reports but assumes no responsibility to do so.

Source: Fitch

Figure 2

Reconciliation Fitch Metrics Telefonica Germany

		2013	2014	1Q15	2Q15	3Q15
Interest bearing debt	(as reported)	**1,448**	**2,430**	**2,609**	**2,505**	**2,258**
Cash and cash equivalents	(as reported)	-709	-1,702	-1,997	-214	-199
Net debt		**739**	**728`**	**612**	**2,291**	**2,059**
Total off-balance sheet debt (8 x long term leases)		2,730	3,344	4,000	4,400	4,800
Net lease adjusted debt		**3,469**	**4,072**	**4,612**	**6,691**	**6,859**
Receivables balance off-BS (factoring)[a]		-	254	292	331	369
Net lease adjusted debt post factoring[a]		**3,469**	**4,326**	**4,904**	**7,022**	**7,228**
Cash flow from operating activities	(as reported)	1,270	1,403	339	293	529
Add back: Restructuring/one-off items (cash)	(Fitch assumption)	-	-409	-12	-46	-90
CFO (Fitch)		**1,270**	**1,812**	**351**	**339**	**619**
Change in working capital (incl. factoring impact)	(as reported)	130	761	-107	-199	104
FFO (Fitch)		**1,140**	**1,051**	**458**	**538**	**515**
Revenue	(as reported)	4,914	5,522	1,901	1,949	1,979
OIBDA	(as reported)	1,237	679	395	450	389
Deduct: Gain on disposal of assets	(as reported)	76	1	15		
EBITDA (Fitch)		**1,161**	**679**	**380**	**450**	**389**
Add back: Restructuring expenses	(as reported)	-	-409	-	-3	-63
Operating EBITDA (Fitch)		**1,161**	**1,088**	**380**	**453**	**452**
Interest paid (net)		-21	-31	-19	-9	6
Taxes paid	(as reported)	-	-6	-	-	-
Dividends received		-	-	-	-	-
Dividends paid to minorities		-	-	-	-	-
Non-recurring/restructuring items added back (cash)		-	-409	-12	-46	-90
Other items before FFO		-	410	109	140	147
FFO		**1,140**	**1,051**	**458**	**538**	**515**
Change in working capital (incl. factoring impact)		130	761	-107	-199	104
CFO		**1,270**	**1,812**	**351**	**339**	**619**
Payments on investments in property, plant and equipment and intangible assets	(as reported)	-664	-689	-308	-291	-270
Spectrum	(as reported)	-	-	-	-976	-1
Dividends	(as reported)	-503	-525		-714	
Non-recurring/restructuring items		-	-409	-12	-46	-90
FCF		**103**	**189**	**31**	**-712**	**259**
Operating lease expense (annualised)	(Fitch assumption; reported annually)	-341	-418	-500	-550	-600
Lease adj. FFO net leverage		**2.31**	**2.71**			**2.77**
Net lease-adjusted debt/(FFO + net interest paid + LT leases)						
Lease adj. FFO net leverage (excluding factoring)[a]		**2.31**	**2.88**			**2.91**
Net lease-adjusted debt post factoring/(FFO + net interest paid + LT leases)						
Net debt/(CFO-capex ex. spectrum)		**1.22**	**0.65**			**2.00**
FFO fixed charge cover		**4.07**	**3.27**			**3.60**
(FFO + net interest paid + LT leases)/(gross interest paid + LT leases)						

[a] Assumes factoring considered from 2014

Source: TEF DE, Fitch

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.